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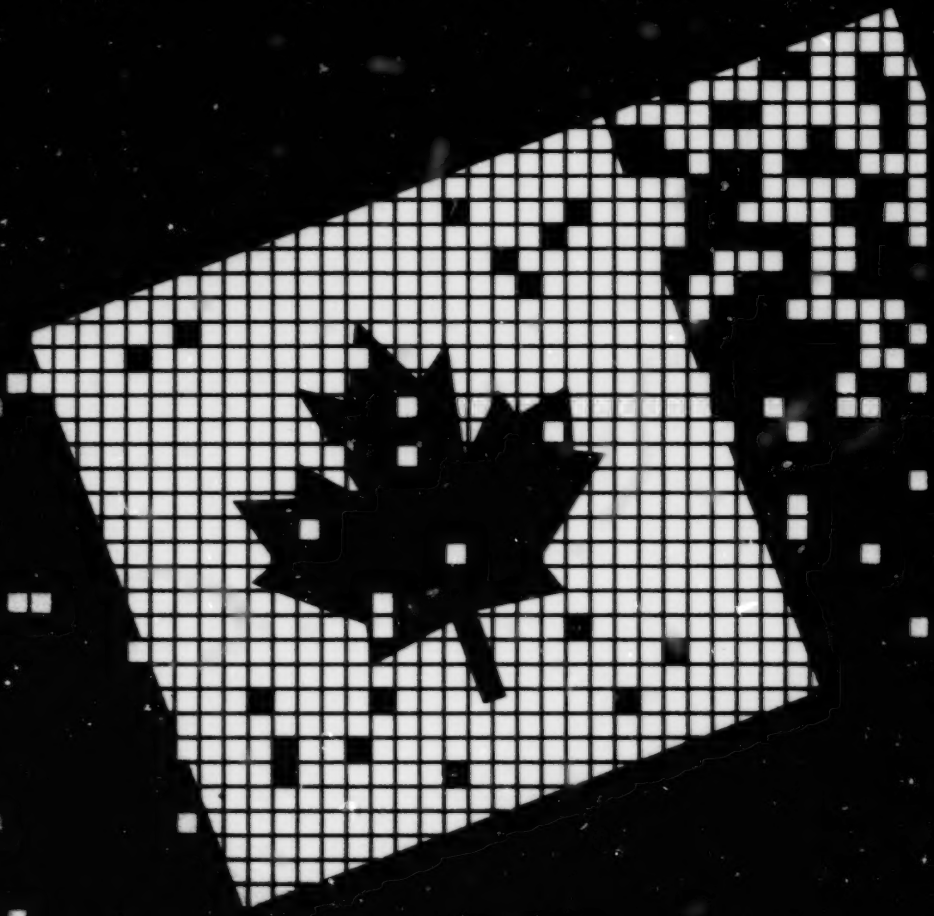

TACKLING THE FEDERAL DEFICIT

Edward A. Carmichael

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C.D. Howe Institute

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Foreword

The time has come to tackle Canada's federal budget deficit. The seriousness of large and persisting deficits poses a threat to Canada's longer-term prospects for economic growth and stability. This threat now outweighs any discomfort that would be generated by a concerted effort to shrink the deficit. The policy issue, therefore, is no longer whether but *how* the deficit should be cut.

The accumulation of federal government debt is now so large that the cost of servicing this debt is one of the fastest-growing items in the annual budget. In a period of high and uncertain interest rates, the deficit easily could grow out of control. To remove this threat, the C.D. Howe Institute estimates that the projected deficit should be cut by $11 billion by 1988. Yet even cuts of this magnitude would just keep the growth of debt and interest charges in step with that of the economy. This means that the already-high burden of the debt on incomes in Canada would remain at high levels but would not continue to grow as it is doing in 1984.

This *Observation* has two purposes. The first is to provide an overview of options for cutting the projected deficit by $11 billion by 1988. We believe that such an overview of the alternatives, some of which are likely to be controversial and unpopular, can provide the basis for a broad public debate on how the federal deficit might be reduced. We expect that many of the options and their underlying rationales will be subjected to vigorous arguments by those who would be directly affected by expenditure cuts or tax increases. Those on the receiving end of spending programs and tax expenditures can become dependent on them in a short period of time. Because these recipients will wish to maintain their positions, they can be expected to oppose cuts. But this should not deter concerned Canadians from debating and refining the measures identified in this study, and proposing new alternatives. The process must begin now.

If serious action is to be taken, Canadians need to be convinced that significant cuts in the federal deficit are possible. They tend to believe that taxes are already too high and that spending cuts are undesirable or exceedingly difficult to achieve. The Institute's objective is to demonstrate not only that the deficit can be reduced, but that expenditure programs and tax rules can be redesigned in ways that lead to simpler, fairer, and more efficient policy. The Institute's objective is not, however, to prescribe the precise tax changes and spending cuts that

should be made. This is a matter for the political process. What we have done is to demonstrate that there are many possible alternatives for getting the job done and that the choices can and must be addressed.

The second purpose is to illustrate some of the choices that will have to be made among tax increases and spending cuts. Different alternatives will distribute the burden of deficit reduction in different ways and will have different economic and political consequences. For example, the entire $11 billion could be found by cutting spending. It could also be obtained by raising taxes. The consequences of these two options, however, would be quite different, as the analysis in this volume clearly illustrates.

Different combinations of tax increases and spending cuts are also possible. If Canadians want to avoid cutting government programs, then the burden will fall on higher taxes or user fees and reduced spending in nonprogram areas such as public-sector compensation. Alternatively, many Canadians have indicated opposition to cuts in social spending. To respect this preference, large cuts in other areas of spending, such as economic development, defense, and external spending, plus tax increases, would be required.

These kinds of trade-offs have to be made, however, and they should be debated by taking account of several important qualifications. First, the burden of deficit reduction should be spread fairly among taxpayers and beneficiaries of government programs. Second, deficit reduction does not have to increase the hardship of disadvantaged groups. One danger in the political process is that vested interests with political influence can shift the burden to those with a weaker voice. Third, the federal government should minimize any contractionary effects by a credible multiyear plan for phasing deficit reduction, and the Bank of Canada should be prepared to offset the contractionary effects with an easier monetary policy.

The debate about deficit reduction will also be a fundamental one about why the federal government is engaged in a number of areas of economic activity and whether or not Canadians are prepared to pay higher taxes to continue to maintain the existing levels of those services. If Canadians are not prepared to do so, a reappraisal of the activity of the private sector will also be required, because much of the responsibility for providing services shed by government and for taking up economic slack will rest with that part of the economy. Thus, regulatory policies that may shackle an active private sector will have to be evaluated and removed as well.

Many Canadians are more concerned about persistently high levels of

unemployment than they are about government deficits. While higher taxes and spending reductions required to bring down the deficit could, if nothing else were changed, slow down economic growth, it is important to understand that a smaller deficit in future will allow more room now for an offsetting, easier monetary policy that will facilitate investment and job creation. More important, if the deficit is not dealt with, economic growth will be lower and unemployment higher in the long term.

There is no choice about facing the issue if Canadians are concerned about the long-term prospects for sustained noninflationary growth of the Canadian economy. There are choices, however, about the means by which the deficit should be reduced. These choices will have to be made soon.

This *Observation* was written by Ted Carmichael, Senior Policy Analyst. He consulted extensively with, among others, the Institute's Council of Advisors, and members of the Institute's Policy Analysis Committee (HIPAC). The manuscript was edited by Barry Norris, and prepared by Linda Kristensen, Betty McGrath, and Irene Matyas. As with all Institute publications of this kind, the views expressed are those of the staff, and are not necessarily shared by HIPAC members.

Dr. Wendy Dobson
Executive Director
August 1984

1

Establishing a Target

Large government deficits have become a common feature of the North American economic landscape. These deficits will not melt away in the current recovery from the deep recession of the early 1980s. In the United States, the federal budget deficit is expected to remain around U.S. $200 billion each year through the end of the decade. Canada's federal deficit reached $30 billion in 1983. Even if the recovery continues over the next four years, the deficit is projected to drop only to $26 billion. This means that federal financial requirements will average about $2 billion per month for the foreseeable future.

When deficits of these magnitudes persist they create risks for the future that outweigh the difficulties of deficit reduction. Persistent deficits cause public debt to accumulate. When the cumulative debt grows faster than GNP, as it is expected to continue to do, more and more of the tax dollar goes to paying interest on the debt. In 1984, twenty-three cents out of every dollar of federal taxes will be required to pay interest on the debt, compared to only ten cents per tax dollar in 1974. If the rapid growth of federal debt is unchecked through time, the entire revenue of the federal government could eventually be required just to service the debt.

Such a situation could not persist for long. It would only be a matter of time before Canadians recognized the instability of the situation and brought about a change in policy. Yet the risk of instability exists in current Canadian federal budget policy.[1] The large deficits projected in the present fiscal plan, announced as part of the February 1984 budget, imply a dangerously rapid accumulation of public debt and associated interest obligations. As the debt accumulates, pressure will build to cut the

[1]This study focuses upon the federal government deficit. In 1983, other levels of government in Canada were in approximate fiscal balance. See Department of Finance, *The Fiscal Plan* (Ottawa, February 1984), p. 50.

deficit. The only real questions are *when* deficit reduction will begin and *how* it will be accomplished

The hard fact about Canada's deficit is that for over 10 years Canadians have accepted more in services and transfers from the federal government than they have been willing to pay for. While deficits and government borrowing are appropriate in a recession, the federal debt cannot be allowed to outpace the growth of national income indefinitely. Eventually deficits must be contained. Delay only makes the problem more intractable and exposes the economy to unnecessary risks. An unexpected downturn, perhaps caused by rising interest rates, could cause the deficit and debt to spiral. There would then be no choice. Severe and sudden spending cuts and tax increases would be required — regardless of the fact that they would worsen the downturn. The only alternatives would be to borrow or print money, either of which could be expected to erode international confidence in Canada's ability to manage its economy. Printing money would, through a disastrous inflation, dissipate rapidly the hard-won gains that have recently been achieved.

Canadians still have time to choose a deficit reduction strategy. But choices are made through the political process and should be based on as clear an understanding of the options as possible. Canadians, because they do not seem to be aware of the gravity of the situation, have not yet

TABLE 1

The Federal Fiscal Plan, fiscal years 1984-88

	1984	1985	1986	1987	1988
	$ billions				
Revenue	72.9	82.5	93.3	103.4	110.3
Expenditure	98.4	107.5	114.5	121.2	128.5
Deficit (National Accounts basis)	25.5	25.0	21.2	17.8	18.2
Budgetary deficit	31.5	29.6	28.0	27.1	26.1
Nonbudgetary surplus	4.5	4.1	4.7	7.4	7.5
Financial requirements	27.0	25.5	23.3	19.7	18.7
	As a percentage of GNP				
Revenue	18.7	19.2	19.9	20.2	19.8
Expenditure	25.3	25.0	24.4	23.6	23.1
Deficit (National Accounts basis)	6.5	5.8	4.5	3.5	3.3
Budgetary deficit	8.1	6.9	5.9	5.3	4.7
Nonbudgetary surplus	1.2	1.0	0.9	1.5	1.3
Financial requirements	6.9	5.9	5.0	3.8	3.4

Note: Data for 1984 are estimated; data for 1985-88 are projected.

Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1984), pp. 5, 40-41.

identified or debated the options.[2] The purpose of this *Observation* is to identify spending and revenue options that could reduce the deficit in the next four years.

The selection of a deficit reduction target depends on two main factors. The first is the likely path the deficit will take if there is no further action than that already planned in 1984. The second is the determination of what would constitute a sustainable fiscal plan. Such a plan would slow the rapid growth of federal debt. It would do so by steadily reducing the deficit at a pace that balances the benefits of lower deficits against the costs of the fiscal restraint required to achieve them.

The federal government's fiscal plan, which accompanied the February 1984 budget, projected the size of the deficit in the next four years.[3] Highlights of the plan are presented in Table 1. The government expects the deficit to decline to 3.3 percent of GNP in calendar year 1988 from 6.5 percent of GNP in 1984. The economic recovery, by reducing stabilization expenditures and expanding revenues, will be the major cause of this projected decline. The cyclically adjusted deficit — that portion that will remain when the economy has recovered fully — will change very little, dropping to 2.9 percent of GNP in 1988 from 3.3 percent in 1984. More important, if the assumed economic growth fails to materialize, deficits will be even larger.[4] If the federal government's recent record of forecasting its deficit several years in the future is taken as a guide, one should not attach too much confidence to the current set of projections. What is discouraging about the record is that the federal

---

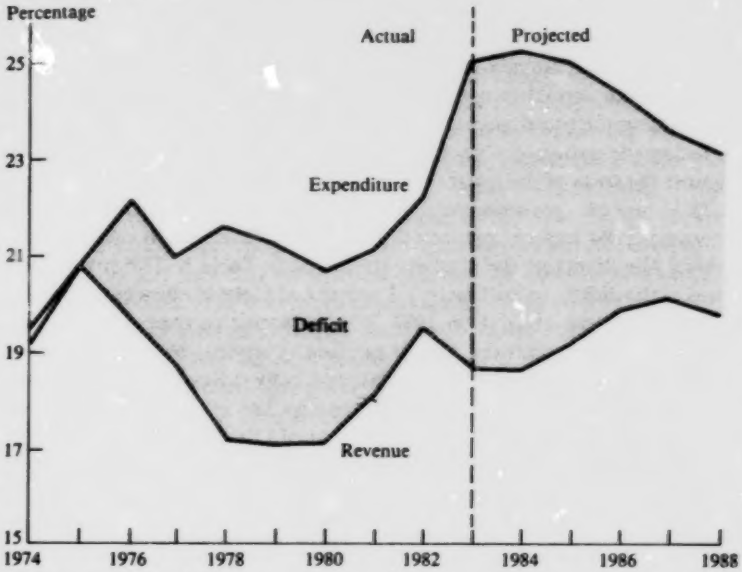
[2]In public opinion surveys conducted by Decima Research, never have more than 2 percent of those polled indicated that they believe the deficit or the national debt constituted the most important economic problem facing Canada. See Ian McKinnon. "What Does the Public Think about Deficits? What Does Bay Street Think about deficits," in David W. Conklin and Thomas J. Courchene, eds, *Deficits: How Big and How Bad?* (Toronto: Ontario Economic Council, 1983).

[3]See Department of Finance. The fiscal plan lays out projections of federal expenditure and revenue on the basis of the government's fiscal year, which ends on 31 March. For example, fiscal 1985 refers to the period from 1 April 1984 to 31 March 1985. The four-year fiscal projections cover fiscal years 1985 through 1988.

[4]The economic assumptions that underlie the fiscal projections call for real economic growth to average 4.0 percent annually from 1983 to 1988. Unemployment is expected to decline steadily to 7.7 percent of the labor force by 1988. Inflation, as measured by the Consumer Price Index, is expected to be stable in the 4.5-5.0 percent range. Some private forecasters have indicated that this outlook is too optimistic and that an economic slowdown before 1988 could derail the government's fiscal projections. See Ronald Anderson, "If Budget Assumptions Falter, Only Promises Will Be Possible," *The Globe and Mail* (Toronto), 24 February, 1983, p. 132.

FIGURE 1

Federal Revenue and Expenditure, National Accounts Basis, fiscal years 1974-88[a]
(percentage of GNP)



[a]Fiscal year ends March 31.

Source: Department of Finance, *The Fiscal Plan* (Ottawa, February, 1984).

government has consistently underestimated the size of future deficits.

The key feature of these deficits is that the federal government has been unable to generate sufficient revenue to finance its growing spending commitments. The growth in those commitments has been, and will continue to be, accounted for by debt servicing costs rather than by an increase in government spending on goods and services and transfers. The current fiscal plan calls for deficit reduction by 1988 to be accomplished by a 2.2 percentage point drop in spending to 23.1 percent of GNP and by a 1.1 percentage point increase in revenues to 18.9 percent of GNP (see Figure 1). Even so, spending will be at historically high levels *mainly because of rising debt servicing costs.* When debt service is excluded, spending represents about the same proportion of GNP in 1983 as it did in 1978. Deficits over the past ten years have continuously increased the federal public debt and the cost of servicing it.

The viability of the fiscal plan hinges on the behavior of the ratio of the federal debt to GNP. This ratio measures what the federal government owes relative to the ability of the economy to generate income. As the ratio increases, other things being equal, an increasing proportion of federal revenue is required simply to pay interest on the accumulated debt. Figure 2 shows clearly how the projected deficits will push up the ratio relative to recent historical experience. Between 1950 and 1975, strong economic growth and the absence of deficit financing reduced federal debt as a proportion of GNP. The slowdown in economic growth after 1975, accompanied by budget deficits, reversed this trend. Then, in 1979, tight monetary policy originated by the U.S. Federal Reserve Board and adopted by the Bank of Canada pushed up interest rates sharply. The recession that finally resulted in 1981-82 caused dramatic increases in the deficit and rapid accumulation of federal debt.

The rising stock of federal debt poses serious risks for the Canadian economy. Chief among them is the potential for large, unpredictable increases in federal interest obligations. Interest payments reflect two factors: the size of the public debt and the interest rate that the government must pay on the debt. Since 1976, federal net debt has increased at an annual rate of 33 percent. Interest rates have increased relative to the early 1970s and have become increasingly volatile. Past and prospective deficits are piling up debt, which increases Canada's vulnerability to higher interest rates imposed by international capital markets. Interest payments are the first claim on government revenues. As the debt grows, an ever-larger part of the budget becomes hostage to unpredictable swings in interest rates.

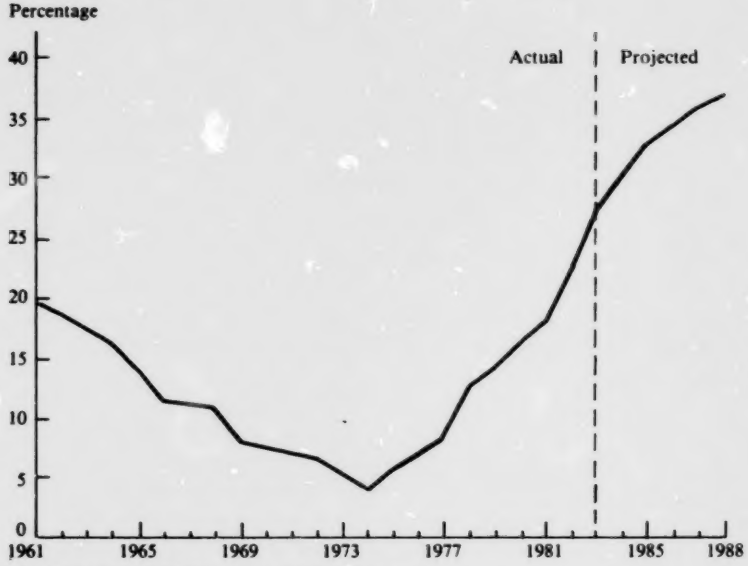
Even if the debt-to-GNP ratio eventually levels off, there are important costs associated with a high debt ratio.[5] First, government borrowing absorbs private-sector savings that would otherwise finance private investment. The reduction of capital formation and the stock of capital inherited by the next generation is one measure of the burden of the debt. It is possible that private investment could be sustained by private foreign borrowing but, in this case, the burden of the debt would show up as increased foreign indebtedness and increased interest and dividend payments abroad.

Second, a rising debt ratio can cause inflation. Inflationary expectations are generated by the belief that persistent deficits will drive up in-

[5]This section is based on Neil Bruce and Douglas D. Purvis, *Evaluating the Deficit: The Case for Budget Cuts*, Policy Commentary no. 4 (Toronto: C.D. Howe Institute, 1984).

FIGURE 2

Federal Net Debt, fiscal years 1961-88[a]
(percentage of GNP)



[a]Net fixed-value liabilities of the federal government.

Sources: Department of Finance, *The Federal Deficit in Perspective* (Ottawa, April 19, 1983), p. 15; and idem, *The Fiscal Plan* (Ottawa, February 1984), p. 58.

terest rates and put pressure on the Bank of Canada to print money. Paradoxically, the current high debt-to-GNP ratio is partly the result of anti-inflationary monetary policy, which raised interest rates and brought on the 1981-82 recession. But if the debt is permitted to continue to rise faster than GNP, it quickly becomes counterproductive to the conduct of anti-inflationary policy.

Third, the rising stock of federal debt has already put a strait-jacket on the conduct of fiscal stabilization policy. Large deficits severely constrained the scope of government actions to offset the worst effects of the recession. The constraint will be even more severe if economic growth falters in the mid-1980s.

For these reasons, additional measures beyond the tax increases

adopted in the April 1983 budget are needed to reduce the deficit and slow down the rate at which federal debt is accumulating.

A major concern about reducing the deficit is that the fiscal restraint required to do so could slow down the economic recovery and postpone even a modest decline in unemployment. But the state of fiscal policy is only one determinant of how strong and durable the recovery will prove to be. Monetary policy — as well as trade, investment, and labor market policies — will also affect the rate of economic growth in Canada. Since 1981, fiscal policy has become significantly more expansionary while monetary policy has generally been aimed at reducing inflation by slowing the growth of nominal GNP. This policy mix — monetary restraint and fiscal expansion — has helped bring inflation down and offset some of the worst effects of the recession.

Action over the next few years to reduce the deficit substantially would also reduce the short-term stimulus to economic activity it provides. A credible deficit reduction strategy, by reducing government financial requirements and expectations of future inflation, could reduce interest rates and thereby increase private consumption, housing, and investment spending to offset the impact of fiscal restraint. If the decline in interest rates proved insufficient to offset the fiscal restraint, then it would be appropriate for the Bank of Canada to adopt a more expansionary monetary policy — that is, a policy consisting of faster money growth and lower interest rates.

Some economists argue that Canada has little scope to pursue an independent monetary policy. The high degree of financial market integration and the minimal barriers to capital mobility in North America mean that there is a limit to Canada's ability to reduce interest rates relative to those prevailing in the United States. Nevertheless, Canada has maintained interest rates considerably below U.S. rates for extended periods in the past.[6] A reduction in the federal deficit, therefore, need not choke off Canada's economic recovery if it is accompanied by a gradual easing of monetary policy. Indeed, the short-term costs associated with fiscal restraint are likely to be small in comparison with the costs of continued large deficits.

By how much should the federal deficit be reduced? A prudent fiscal plan would require, at a minimum, that the debt-to-GNP ratio stop ris-

[6]From 1969 through 1973, Canadian interest rates were consistently below those in the United States. During most of 1973, Canadian rates were from one to two percentage points lower.

ing. Professors Neil Bruce and Douglas Purvis of Queen's University have argued in a recent Institute *Policy Commentary* that more than this is desirable.[7] They believe that a prudent budget plan would see the debt-to-GNP ratio decline eventually to the level attained prior to the back-to-back recessions of 1980 and 1981-82.

Bruce and Purvis separate the federal deficit into three components. The "cyclical" component — an estimate of that part of the deficit that results from the economy operating well below its potential — was negligible in 1979, at the peak of the last business cycle, increased by 1983 to over $11 billion and, based on Department of Finance projections, is expected to decline by 1988 to just over $1 billion. The "trend" component represents the magnitude of the deficit that is consistent with maintaining a stable target level of the debt-to-GNP ratio. The trend rate of nominal GNP growth, assuming an inflation rate of 5 percent, is approximately 8-9 percent annually. Thus, a deficit equal to 8-9 percent of the target debt level for the economy would be consistent with a stable debt-to-GNP ratio. This trend component of the deficit is estimated to be $4 billion in 1983, and is expected to rise to $5 billion by 1988. When these two components are subtracted from the actual deficit, the remainder provides an estimate of the "imprudent" component of the deficit — that part that cannot be justified either by cyclical factors or by the trend growth of national income. Bruce and Purvis argue that the imprudent component of the deficit must be eliminated by 1988 to ensure that the debt-to-GNP ratio stabilizes and then gradually returns to its pre-recession level. This would require reducing the planned deficit in 1988 by $11 billion to $7 billion (about 1 percent of GNP) from its currently projected level in fiscal 1988 of $18 billion.[8]

Adopting this target would halt the climb of the federal debt-to-GNP ratio. Current projections indicate that this ratio will rise continuously to 36 percent of GNP in 1988 from 29 percent in 1984, as shown in Appendix Table A-1. That table also shows an alternative path that would eliminate the imprudent component of the deficit by 1988. In that case, the debt-to-GNP ratio would rise to 34 percent in 1986 and then begin to decline gradually. Following this plan would mean that the cumulative

[7]See Bruce and Purvis.

[8]This target of $11 billion is based on the current fiscal plan, which itself is based on an underlying set of economic projections. To the extent that actual economic performance differs from the projections, the target could be altered. For example, if economic growth is stronger and the actual deficit declines more quickly, then the target deficit reduction would be smaller.

federal debt would be $20 billion smaller in 1988 than currently projected. Debt servicing costs alone would be reduced by $2 billion.

Deficit reduction of this magnitude represents an attainable *minimum* target. We cannot do less than that without incurring the costs of high federal indebtedness cited above.

How can we achieve this minimum target? Faster economic growth and a more rapid decline in unemployment would be the best method of bringing the deficit down. Reducing the regulation of economic activity, strengthening competition policy, reducing barriers to international trade, and improving the climate for foreign investment could all enhance Canadian productivity and economic growth prospects. While many of these changes are needed, their implementation and ultimate impact on economic growth would take several years to be felt. For this reason, any strategy for effective deficit reduction over the next few years will have to involve some combination of spending reductions and tax increases. There is no painless way of cutting $11 billion from the projected 1988 deficit. It is possible to achieve this target entirely on the expenditure side of the budget or entirely on the tax side. Doing so, however, would require radical expenditure or tax changes that would concentrate the burden of reducing the deficit on particular groups in society. It should also be recognized that spending in some areas may have to be increased and that some taxes ought to be reduced in the next few years. To reach a specific deficit reduction target would then imply deeper spending cuts or larger tax increases elsewhere in the budget. Figure 3 graphically summarizes three deficit reduction strategies.

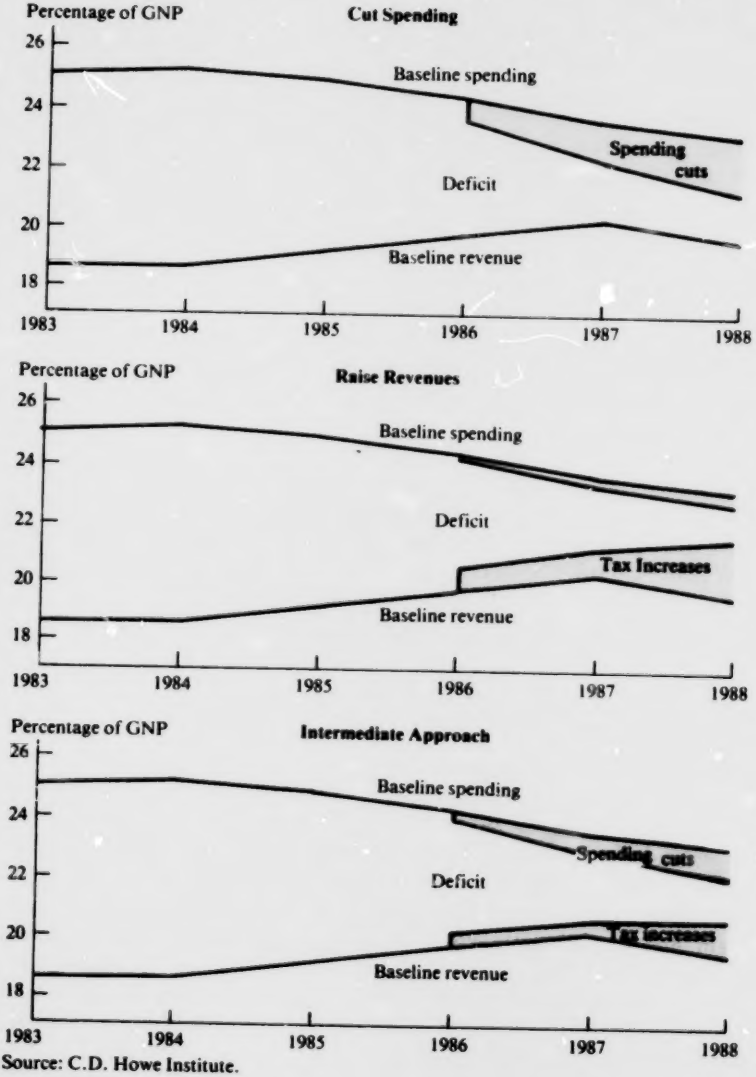
Spending cuts. Cutting the deficit entirely on the expenditure side of the budget would mean reducing planned spending to 21 percent of GNP by 1988, while planned revenues would be 20 percent of GNP. The ratio of federal spending to GNP would return to pre-recession levels.

Cutting $11 billion from projected 1988 spending would involve a reduction in the rate of planned spending growth to 4.5 percent per year from 7 percent over each of the next four fiscal years. Achieving this reduction would require a significant improvement in the efficiency of government programs, a reduced government role in economic development, and less ambitious defense and foreign aid commitments. But such measures would not be enough. Major spending cuts would also require fundamental change in the entitlement of Canadians to social transfers.

The difficulty of achieving deficit reduction on the expenditure side is illustrated by the following examples:

FIGURE 3

Three Deficit Reduction Strategies.



Source: C.D. Howe Institute.

- If a wage freeze was imposed on federal employees in 1985, the saving in 1988 would be less than $2 billion.
- If defense and foreign affairs spending was held to zero real growth beginning in 1985, the saving in 1988 would be $1.5 billion.
- If government transfers to business for economic and regional development were cut in half over the next four years, the saving in 1988 would be $4 billion.
- If major social transfers to individuals were income-tested, the saving in 1988 would be $3 billion.

Any strategy to reduce the deficit on the expenditure side of the budget would have to consider some or all of these controversial measures.

Revenue increases. Achieving the target by raising taxes would require decisions about which taxes to increase to generate $9 billion per year by 1988. Higher revenues would slow the accumulation of public debt, and reduced debt service costs would cut the deficit by an additional $2 billion. Tax increases of this magnitude would raise federal revenues to 22 percent of GNP, higher than the previous peak of 21 percent of GNP reached in 1975, and would be difficult to achieve given the current tax structure.[9] Large increases in tax rates could stifle initiative and push a greater proportion of economic activity into the underground economy. An alternative is tax reform: either the existing tax base could be broadened by reducing tax preferences to individuals and businesses, or altogether new taxes could be imposed to bring the deficit down.

Balanced spending cuts and tax increases. An intermediate approach would be to spread the burden of deficit reduction more evenly among taxpayers and beneficiaries of spending programs. Less radical expenditure cuts could achieve a reduction in spending to 22 percent of GNP and more modest changes in the tax structure could produce revenues equal to 21 percent of GNP by 1988. Although this strategy would tackle the deficit on all fronts, it would still leave federal spending and revenues at historically high levels relative to GNP.

Attempts to implement any one of these broad strategies would quick-

[9]Federal tax increases could generate sizable windfalls for the provinces. For example, an increase in federal personal income tax would automatically raise provincial income tax revenues in all provinces — with the exception of Quebec, which levies its own personal income tax — because provincial taxes are set as a fixed proportion of federal tax payable. The provincial windfall could be offset by reducing federal transfers to the provinces, a measure that would further reduce the federal deficit.

ly run into powerful arguments against cutting particular spending programs or raising particular taxes. Some will argue that deficit reduction measures are politically impossible; others that the social cost would be too great; and still others that Canada will lose competitiveness if taxes are raised or business subsidies reduced. Special-interest groups are likely to oppose such measures even though they would improve Canada's overall prospects for better living standards and economic stability in the future. For this reason, achieving deficit reduction will require strong political leadership. To command public support, any deficit reducing plan will have to spread the costs widely and evenly so that no group within society bears a disproportionate burden.

Outline of the Study

This study investigates options for reducing the federal deficit. Chapter 2 focuses on measures to reduce spending growth and presents economic criteria by which these options might be evaluated and choices made. This chapter then assesses possible cuts in major spending programs to determine both their potential contribution to deficit reduction and their economic impact. Chapter 3 explores three ways to raise revenues and examines the ability of each to distribute the tax burden evenly and to reduce flaws in the existing tax structure.

In both Chapters 2 and 3, readers should keep in mind several cautions with respect to the dollar values of the options discussed. First, the dollar estimates are approximations only of the impact of these options on the federal deficit. The value of each option has been calculated separately, as if none of the others was adopted. In some cases, reduction of one program might result in expansion of another. If regional economic development grants were reduced, for example, there might be some induced increases in unemployment insurance or social assistance payments in the affected region. In general, the impact on the deficit of adopting a group of options would be different from that of adopting each option separately.

Second, any spending cut or tax increase will have the additional effect of reducing the growth of the federal debt and the cost of servicing it. A spending cut or tax increase of $1 billion in 1985 would lower public debt by $3 billion by 1988 and reduce interest costs by about $300 million in that year. The options that are discussed do not take into account the saving in interest payments that would result.

Third, any major effort to reduce the deficit, by itself, would alter the

assumptions about economic performance that underlie the federal government's current fiscal plan. These assumptions are consistent with a variety of fiscal policies, however, if adjustments in monetary policy were adopted to offset the change in fiscal stance. Whether the underlying economic assumptions should be changed, therefore, depends on the exact mix and timing of deficit reduction measures and the implementation of offsetting monetary actions. This study evaluates all deficit options on the assumption that fiscal changes would be phased in gradually and offset by monetary policy adjustments.

The final chapter of the study addresses the underlying choices that are inherent in strategies to reduce the deficit and the potential obstacles to making these choices. What is at issue is not only how to improve the performance of the Canadian economy in the years ahead. Reducing the deficit will also require Canadians to decide what role they want the federal government to play in the economy. Before action can be taken that has Canadians' support, these issues must be debated. But the breathing space for debate and choice is limited. If the federal government does not adopt a strategy for reducing the deficit soon, we may find harsh measures thrust upon us suddenly and painfully. The first step toward fiscal prudence is to understand the consequences of continuing down the present path. The next step is to debate how to establish a more prudent path.

2

Cutting Federal Spending

One way to reduce future deficits is to lower the growth of planned federal spending. If deficit reduction is to be achieved by this route, however, Canadians will be forced to make judgments about the value and effectiveness of government spending. Once a consensus on target expenditure levels is reached, further decisions will be required on the types of government spending that should be reduced. The challenge will be to reduce spending in areas where it is perceived to be excessive, ineffective, or of relatively low national priority.

Federal spending has risen steadily in Canada. Between 1964 and 1984, it rose from $8 billion or 16 percent of GNP to $98 billion or 25 percent of GNP. Current plans call for federal spending to grow by 7 percent annually, to reach $128 billion by fiscal 1988. Limiting spending growth to 4.5 percent annually would cut $11 billion from the projected deficit in fiscal 1988 and achieve the target of reducing the deficit to 1 percent of GNP.

The objective of this chapter is to identify options for expenditure savings. At first glance, reducing planned spending by $11 billion by 1988 may not appear to be a difficult task. But when one realizes that three-quarters of federal spending is for public debt interest and statutory transfer programs, the challenge of expenditure restraint becomes clearer. In theory, the federal government has discretionary power to reduce statutory transfer payments. In practice, making changes to such programs is time-consuming and fraught with difficult political and economic choices. Recognizing the short-term, nondiscretionary nature of a large portion of federal spending should not lead to the conclusion, however, that solutions to the deficit problem cannot be found on the expenditure side of the budget. Instead, it should lead to a search for more effective means of delivering federal government programs.

Our investigation of potential areas for spending cuts is based on the criterion of the program's ability to achieve the economic and social ob-

jectives that were originally set for it. Broad federal objectives, as laid out in the annual federal expenditure plan, include the following:

- fostering industrial and regional economic growth and development;
- providing a social safety net;
- providing effective justice and law enforcement;
- providing national defense and promoting and protecting Canada's interests abroad;
- equalizing the fiscal capacity of the provinces.[1]

Any evaluation of the effectiveness of program expenditures should be based on the impact of the expenditures on economic efficiency, income distribution, and economic stability.

Economic efficiency. Government spending decisions significantly influence the allocation of resources in the Canadian economy. Efficiency in the allocation of resources is achieved if an additional dollar spent by government can be put to no better use than an additional dollar spent by private-sector taxpayers. It is widely accepted that the role of the federal government in providing public goods and services such as national defense, a legal and justice system, and public investment infrastructure contributes to economic efficiency, although the appropriate level of expenditure is a subject of controversy. Reductions in the spending on such public goods, therefore, require either a broad political consensus or the achievement of improved cost effectiveness.

Government grants and transfer programs also affect the allocation of resources within the private sector. Government incentives often replace market incentives. In some cases, avoiding socially unacceptable market outcomes warrants government intervention. In others, government spending distorts private decisions and slows adjustment to changing domestic and international economic circumstances. Options for reducing government spending should be judged on their ability to remove economic distortions and speed adjustment. By allowing labor and capital resources to flow into their most productive uses, such cuts would improve the competitiveness and growth potential of the private sector.

Income distribution. Government spending programs alter the distribution of income and opportunity among individuals and groups within the economy. Because many federal transfer programs make equal payments

[1]Government of Canada, *1984-85 Estimates, Part I: The Government Expenditure Plan* (Ottawa: Supply and Services Canada, 1984).

to qualified recipients without regard to their income, much of the redistribution occurs within middle-income groups. Expenditure options should be judged on the basis of their ability to improve the effectiveness with which they achieve redistributional goals.

Economic stability. Government programs such as unemployment insurance and social assistance act as built-in stabilizers to the economy. These programs inject spending power into the economy during downturns and withdraw it during booms, thus reducing the likelihood of a persistent recessionary or inflationary spiral. Options for reducing planned expenditures, therefore, should be evaluated for their impact on the ability of the fiscal system to counteract both economic recession and inflationary pressures.

The use of these criteria can direct the search for spending reduction options. Indeed, some of these options have merits beyond their immediate contribution to deficit reduction. Reductions in some government subsidies could improve the efficiency and competitiveness of the private sector. Increasing the role of market incentives could increase the ability of the economy to adapt more quickly to changing international economic circumstances. Improving the design and delivery of essential social programs could provide greater assistance to the poor at a lower level of total spending. In short, application of these criteria would lead to deeper spending reductions in programs that are outdated or ineffective in meeting basic social and economic objectives.

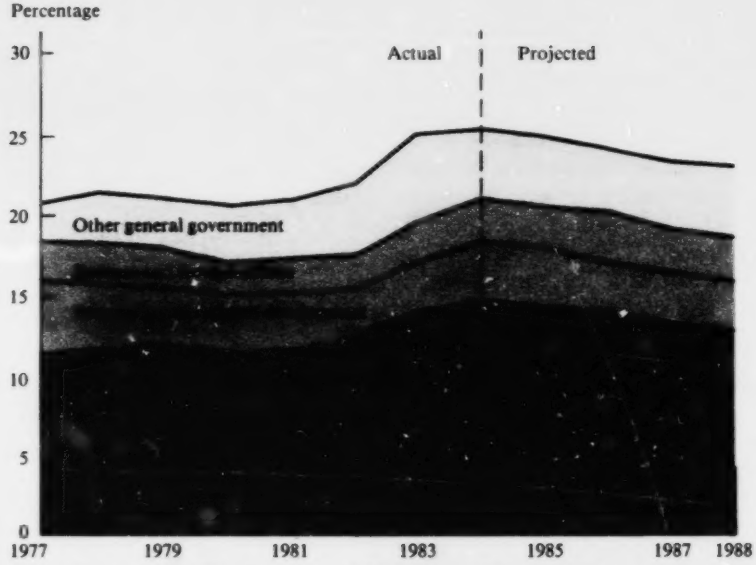
Major Expenditure Functions

Total federal spending has increased sharply to over 25 percent of GNP in fiscal 1984 from 21 percent of GNP in 1977. Total spending can be broken down into five major categories: economic and regional development, social spending, defense and foreign aid, public debt charges, and other general government spending (see Figure 4). These spending categories correspond to the federal cabinet committee system within which program plans are formulated and spending decisions negotiated and approved. They also correspond to the major economic and social objectives of federal programs already cited.

Public debt charges, social spending, and economic and regional development spending have each increased rapidly since fiscal 1979. Higher public debt charges have resulted from a string of large budget deficits over the past 11 years and from the high interest rates of recent

FIGURE 4

Federal Government Expenditure, fiscal years 1977-88
(percentage of GNP)



Source: Department of Finance, *The Fiscal Plan* (Ottawa, February, 1984).

years. New spending initiatives in the areas of social and economic development have been augmented since late 1981 by higher countercyclical spending — both automatic, as in the case of increased unemployment insurance and social assistance payments, and discretionary, as in the case of job creation programs, housing grants, and capital spending projects.

According to the government's medium-term fiscal plan, total spending is expected to decline to 23 percent of GNP by fiscal 1988. This projection is based on the assumption of five years of steady economic growth and declining unemployment, an outcome that may prove difficult to achieve. Federal spending is still projected to be 2 percentage points higher at the end of the period than ten years earlier, with almost the entire increase accounted for by higher debt service costs. Public debt charges can only be controlled indirectly by reducing federal deficits and

the public debt.[2] The search for expenditure cutting options must focus, then, upon achieving cost savings in the four remaining spending categories.

Expenditure Reduction Strategies

The federal government could adopt any one of several alternative strategies to reduce spending growth. Some strategies involve reducing spending without reducing government services. This could be achieved by raising efficiency in the public service, by restraining public-sector compensation growth, by increasing user charges for government services, or by selling crown corporations that require continuous financial support. While these options could play an important role in reducing the federal deficit, they cannot, by themselves, do the whole job. Thus, it is also necessary to examine options for cutting spending that would entail some reduction in government services.

One way to achieve a lower target level of spending without cutting services is to *improve efficiency in the federal government*. Efficiency can be improved by reducing the manpower, capital, and material inputs currently used to deliver government programs. Consolidating government programs and reducing the number of government departments could create some expenditure savings. The consolidation of the Department of Industry, Trade and Commerce (DITC) with the Department of Regional Economic Expansion (DREE) in 1983, for example, resulted in both lower spending and reduced staffing levels in the new Department of Regional Industrial Expansion (DRIE).

The scope for expenditure savings through more efficient management is currently unknown. The findings of the Grace Commission in the United States, which estimated the potential impact of applying business management techniques of inventory control, information systems design, human resource utilization, and financial management to government, suggest that savings could be substantial.[3] More information on the scope for improved management techniques and incentive systems in the Canadian federal government is clearly needed.

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[2]It might be possible to directly influence public debt charges by issuing indexed government bonds. These bonds could provide an assured inflation-adjusted yield of 3 or 4 percent. Lenders might accept lower real yields if such yields were guaranteed because they would not have to be concerned about uncontrollable public debt leading to rising inflation and interest rates. If accepted by the public, these indexed bonds could lower the cost of servicing the public debt and reduce the deficit.

[3]William B. Johnson, "Saving Grace," *Across the Board* 21 (April 1984): 3-5.

Another way to achieve expenditure savings without reducing programs is to *constrain the growth of wages, salaries, and benefits of federal employees.* Federal compensation costs are expected to be $13 billion in fiscal 1985, or about 11.5 percent of total spending. Compensation has been controlled in recent years, first by the Anti-Inflation Program of 1975-78 and then by the "6 and 5" program of 1982-84. Although federal wage settlements averaged 5.5 percent in 1983, total compensation costs increased by 9.8 percent, reflecting merit increases, overtime, a small increase in staffing, and other compensation adjustments.[4]

The government's medium-term fiscal plan does not provide separate projections of compensation costs. The *Main Estimates 1984-85* project an increase in total compensation of 4.6 percent, less than half the increase of the previous fiscal year.[5] The *Main Estimates* have tended, however, to underestimate actual compensation costs in recent years. Compensation is the largest component of total current spending on goods and services and usually grows at a similar rate. On this basis, federal compensation is likely to increase at a 6 percent rate on average over the course of the fiscal plan. This continued growth in federal compensation contrasts with measures taken by some provincial governments to freeze public-service pay levels.

Table 2 shows two illustrations of the impact of federal compensation restraint. The first of these illustrates the expenditure savings that would be achieved if compensation growth was limited to 3 percent each year. The second illustrates the impact of a one-year compensation freeze in fiscal 1986 followed by a limit of 3 percent annual growth in compensation. The potential savings indicate that, contrary to the popular belief, freezing government wages could not quickly eliminate the deficit. Compensation restraint could play a role in a comprehensive deficit reduction strategy but, by itself, it could generate only $1-2 billion in expenditure savings by fiscal 1988 if either of these options was adopted.

While some scope exists for compensation restraint, hazards also exist if such a policy is pushed too far. Excessive wage restraint could drive away many of the most productive federal employees at all levels, from clerical to technical and professional workers. This would produce expenditure savings, but only at the cost of reducing the productivity and

[4]Statistics Canada, *Estimates of Labour Income,* Cat. no. 72-005 (October-December 1983).

[5]Government of Canada, *Main Estimates 1984-85* (Ottawa: Supply and Services Canada, 1984), pp. 1-48.

TABLE 2

Options for Compensation Restraint, fiscal years 1986-88

Option	Potential expenditure savings ($ millions)		
	1986	1987	1988
Limit compensation growth to 3 percent per year	400	800	1,250
Freeze compensation in 1986, followed by 3 percent compensation growth	750	1,200	1,700

Source: C.D. Howe Institute.

effectiveness of the public service. A more flexible, merit-oriented pay system would be a superior option to across-the-board wage restraint.

A third method of reducing net federal spending without cutting programs is to *increase charges for public services.* This approach has the benefit of improving equity by requiring individuals or firms to pay for the government services they use. Some federal user fees already exist but, in many cases, they remain well below the cost of operating the service and the federal government covers any deficit out of general revenue. Raising user fees, therefore, could reduce federal payments — expected to reach almost $1.4 billion in fiscal 1985 — to such crown corporations as Canada Post, VIA Rail, and CN Marine.

A fourth way of reducing federal outlays without cutting public services is to *sell some federal crown corporations.* Net loans, investments, and advances to crown corporations such as Petro-Canada and Canada Development Investment Corporation, which owns de Havilland Aircraft Limited and Canadair Limited, have amounted to about $1 billion per year recently.[6] The federal government could reduce its involvement in such corporations by selling off some assets, dismantling some operations, and freezing loans and investment at current levels. While the sale of such assets would provide only a one-time increase in federal revenue, future commitments to cover operating deficits of these crown corporations would be eliminated. Actions of this type could reduce federal spending by $500 million per year. Similarly, the sale of profitable crown corporations such as Air Canada would provide a one-time boost to federal revenue but would have no lasting effect on ongoing federal expenditure.

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[6]Receiver General for Canada, *Public Accounts of Canada, 1982-83, Vol. 1, Summary Report and Financial Statements* (Ottawa: Supply and Services Canada, 1983), pp. 1-11.

Finally, if the government is unable to achieve the desired spending cuts by increasing efficiency, restraining public-sector compensation, increasing user fees, or selling crown corporations, then such reductions can only be achieved by cutting back government programs. If this approach is adopted, the government should concentrate its cuts on programs that are relatively ineffective or outmoded. Program cuts will have the best chance of public support if they are perceived both to be fair and to improve the effectiveness of federal spending.

Specific Options for Program Cuts

Economic and Regional Development

Eighty percent of Economic and Regional Development (ERD) spending is concentrated in four major policy areas: energy, industrial and regional development, transportation, and agriculture. Over 60 percent of this spending is accounted for by transfer payments to government and corporate business enterprises and to individuals and unincorporated businesses (see Tables A-3 and A-4). An important aspect of ERD spending is that much of it is discretionary in the sense that expenditure levels are not determined by statutory formulas as is the case with many social spending programs. Federal action to reduce ERD spending levels could be achieved without lengthy federal-provincial negotiations.

The federal government undoubtedly has a role to play in economic and regional development. A 1981 federal discussion paper emphasized three aspects of this role:

- promoting balanced growth in all areas of Canada by supporting investment and development activities that strengthen the economic base and the links between regions;
- strengthening the performance of markets and their ability to adapt to change; and
- supporting investment activities that would provide significant benefit to Canada but that are beyond the capacity of the private sector.[7]

These roles — the creation and maintenance of infrastructure, adjustment assistance, and assumption of large-scale, risky development projects — are accepted forms of government economic activity. Many ERD spending programs, however, either fail to meet these criteria or, in some

[7]Government of Canada, *Economic Development in the 1980s* (Ottawa: Supply and Services Canada, November 1981), p. 11.

cases, work against their achievement. Many ERD grants and subsidies blur or distort market signals, redirect the allocation of labor and capital, and slow the process of economic adjustment. Table 3 summarizes options for reducing ERD spending.

TABLE 3

Options for Reducing Economic and Regional Development Spending, fiscal year 1988

Option	Potential expenditure savings ($ millions)
Phase out oil conservation grants	400
Reduce PIP grants to one-half current level	925
Reduce payments to AECL and Petro-Canada	400
Redesign and scale down IRDP program	500
Reduce transportation subsidies; increase user fees	300
Redesign farm stabilization programs to increase producers' contributions; reduce price supports	300

Source: C.D. Howe Institute.

Energy

The two oil price shocks that occurred in the 1970s provided the rationale for a significant increase in federal involvement and spending in the area of energy policy. Recent moves by Canada to raise the domestic crude oil price toward the world level, however, have eroded the rationale for many of Canada's energy grant programs. A move to the world price combined with a return of exploration and development incentives to the tax system would justify a phase-out of the complex energy regulatory and expenditure program.

Of the almost $4 billion in energy-related spending planned for fiscal 1985, 80 percent is accounted for by federal grants and transfer payments. Most of the grants accrue to private and crown corporations in the petroleum and alternative energy industries. The remainder benefit energy consumers. The proliferation of energy-related transfers reflects the federal government's decision not to rely on market-determined prices for oil and natural gas. The federal government has maintained the price of domestically produced crude oil below the price of imported oil since the original oil shock of 1973. Many federal energy programs provide incentives for energy (particularly oil) conservation to offset the effect of holding the oil price down: the Canadian Home Insulation Program will provide $189 million in fiscal 1985 to qualifying homeowners who insulate their homes; the Oil Substitution-Conversion Assistance

Program will provide $126 million to homeowners who convert from oil to electricity or natural gas. To promote increased natural gas use in Quebec and the Atlantic provinces, the federal government is subsidizing the extension of the gas distribution system at a cost of $337 million. Numerous other grants are available for firms that switch from oil to other fuels and for firms that develop new conservation or alternative energy technologies.

The Petroleum Incentives Program (PIP) is the largest energy grant, with a planned spending level of $1.6 billion in fiscal 1985. PIP grants were introduced as part of the National Energy Program of 1980 as a replacement for tax-based depletion allowances.[8] The shift to a grant system allowed the federal government to promote Canadianization of the petroleum industry by providing greater incentives for exploration and development for Canadian-owned than for foreign-owned firms. PIP grants range from 80 percent of allowable expenditures for Canadian firms on federal lands to zero for foreign-owned firms on provincial lands. The PIP program has been criticized by the Auditor General on the grounds that the federal government has limited control over spending levels that are determined entirely by industry exploration activity, that the high grant proportion reduces incentives for cost efficiency by participating firms, and that there is no way of determining whether the program is effectively achieving the objectives of ensuring Canadian energy security and raising Canadian participation in the industry.[9]

The June 1983 federal-provincial energy agreement moved Canadian oil and gas prices closer to world levels. Indeed, newly discovered and synthetic oil was granted the equivalent of the world price in September 1981. Consumer prices for some fuels, such as gasoline, are actually higher in Canada than in the United States because of greater direct and indirect taxes on petroleum in Canada. As Canadian prices increasingly reflect international prices, the rationale for many of the energy grant programs is eroded. Consumers faced with international prices can make their own decisions on the efficient use of energy without special conservation incentives. A phased elimination of major energy conservation grants could save $400 million in federal spending in fiscal 1988.

The PIP program has brought about a major redirection of energy ex-

[8]For a discussion of the rationale and consequences of the National Energy Program, see Edward A. Carmichael and James K. Stewart, *Lessons from the National Energy Program*, Observation no. 25 (Toronto: C.D. Howe Institute, 1983).

[9]Auditor General of Canada, *Report to the House of Commons, Fiscal Year Ended 31 March 1983* (Ottawa: Supply and Services Canada, 1983).

ploration from Western Canada to the frontier regions. In so doing, it has worsened the recession in Western Canada and thereby has had a perverse effect on regional economic stability. The urgency of developing frontier oil, which seemed acute at the inception of the PIP system, has diminished as the world oil market situation has turned to one of persistent excess capacity. The current energy situation does not warrant the continuation of PIP grants in their present form. One option would be to reduce the rate of PIP grants and to reduce or eliminate their regional differentiation. Cutting the average grant in half could save $925 million in fiscal 1988. Another option would be to eliminate the PIP program altogether and partially offset the impact on the industry by reducing energy taxes. This could involve either a reduction in the Petroleum and Gas Revenue Tax or a return to a less generous tax-based depletion system.[10]

A significant proportion of energy spending is accounted for by payments to two crown corporations, Atomic Energy of Canada Limited (AECL) — $331 million — and Petro-Canada — $520 million. AECL, along with the rest of the Canadian nuclear industry, is currently facing a very uncertain future. There have been no firm orders for CANDU reactors since 1978 and nuclear power faces problems around the world. The federal government decided in 1982 to continue to support the industry until the mid-1980s, when prospects should be clearer.[11] If prospects do not improve, AECL could be scaled down and parts of its activities transferred to private firms in the nuclear industry, thereby reducing federal payments.

Petro-Canada is the federal government's oil company. It has experienced extraordinary growth based on large annual infusions of government funds and other assistance. Since its inception in 1976, Petro-Canada has grown to become one of this country's largest oil companies, with assets of $8.2 billion in 1983. Petro-Canada has used annual payments from the government both to acquire foreign-owned oil companies and to augment its capital spending budget to help finance an aggressive frontier exploration program. A reduction in federal payments

[10]There would be no impact on the deficit if PIP was replaced with an equally generous tax-based incentive. If the PIP grants were replaced with a simple tax write-off for frontier exploration, however, the foregone revenue would be only about 65 percent of the costs under the PIP program. See "Federal Official Rebutting Critics of Oil Incentive Plan," *The Globe and Mail* (Toronto), 9 June 1984, p. B5.

[11]Department of Energy, Mines and Resources, *Nuclear Industry Review* (Ottawa: Supply and Services Canada, 1982).

to Petro-Canada would force the company to be more selective in its exploration program and to rely more on funds borrowed in the private capital market. In sum, a reasonable target would be to reduce payments to AECL and Petro-Canada by $400 million by fiscal 1988.

Industrial and Regional Development

Federal industrial and regional development policies play an important role in the government's overall economic development strategy. During the 1970s, industrial sector policies carried out by DITC and regional policies carried out by DREE came under heavy criticism for an apparent conflict in their objectives. Sectoral policies aimed to create internationally competitive Canadian industries by supporting export development, product innovation, and industrial modernization and rationalization. Regional policies, on the other hand, have financed infrastructure development and have subsidized firms to locate plants in low-income areas of the country, potentially limiting industry rationalization and improved competitiveness. Indeed, University of Western Ontario economist Thomas Courchene argued that regional development grants and other federal transfer policies were partly to blame for the continued existence of regional disparities in Canada. He contended that dependence by the have-not provinces on federal regional development grants blocked economic adjustment in those regions and kept both wages and unemployment high.[12]

The Economic Council of Canada, in a review of regional policy in the 1970s, concluded,

> in the last two decades, a period roughly corresponding with the introduction of explicit policy instruments aimed at reducing regional disparities and promoting regional economic development, there appears to have been little change in income and employment gaps among regions.[13]

Part of the reason for the apparent lack of success of federal grants in achieving their objectives is the finding, which applies to both industrial and regional incentives, that many of the projects that received federal grants would have been undertaken regardless of whether or not the

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[12]Thomas J. Courchene, "Avenues of Adjustment: The Transfer System and Regional Disparities," in Michael Walker, ed., *Canadian Confederation at the Crossroads: The Search for Federal-Provincial Balance* (Vancouver: Fraser Institute, 1978), pp. 145-186.

[13]Economic Council of Canada, *Living Together: A Study of Regional Disparities* (Ottawa: Supply and Services Canada, 1977), p. 3.

grants were available. For example, the Economic Council found that, in the Atlantic region, only 25 percent of firms receiving DREE grants would not have located in the region without the grants. Forty-one percent of the firms receiving grants would have located there anyway, while no reasonable judgment could be made for the remaining 34 percent.[14] Thus, for many of these firms the grants are a windfall gain.

Evidence of this sort may have been partly responsible for the creation of DRIE in 1983. It was argued that the goal of policy should shift to promoting adjustment rather than regional development.[15] This departmental amalgamation also reflected the views of the federal government's 1981 discussion paper, *Economic Development in the 1980s*, and charged DRIE with the role of promoting megaproject development and the ensuing "spin-offs" in all regions of the country. The cancellation and deferment of many megaprojects has limited DRIE's new policy thrust and left the department conducting much the same types of grant programs as its predecessors.

DRIE expenditures in 1985 are projected to be $1.5 billion, of which $1.2 billion is accounted for by grants and contributions to Canadian industry. Industrial programs have been reorganized and consolidated in the Industrial and Regional Development Program (IRDP).[16] This program provides support under six categories: business climate, innovation, plant establishment, modernization and expansion, marketing, and restructuring. The location of a proposed activity, in part, determines its level of support. The program divides Canada into four levels of regional disparity, with levels of assistance graduated in corresponding tiers. Tier One is the basic level of support and applies to the most developed areas of Canada. Support levels are increased in the remaining tiers.[17]

There are three basic options for reducing IRDP expenditures. First, there could be a proportional across-the-board reduction in spending on each of the program's components. This approach would retain the existing emphasis given to each of the program categories as well as the regionally differentiated incentives. Second, incentives could be reduced

[14]Ibid., p. 162.

[15]N.H. Lithwick, "Regional Policy: The Embodiment of Contradictions," in G.B. Doern, ed., *How Ottawa Spends Your Tax Dollars 1982* (Toronto: Lorimer, 1982), p. 142.

[16]Many of the programs of DREE and DITC continue to exist within the IRDP program. For example, payments continue to be made under the *Regional Development Incentives Act*, the Defence Industry Productivity Program, and the Shipbuilding Industry Assistance Program, to name a few.

[17]Hon. Ed Lumley, Address to the Canadian Manufacturers' Association, Toronto, 23 January 1984.

in the more developed regions of Canada by, for example, eliminating support to Tier One areas. Third, support could be reduced to some program categories such as plant establishment or innovation. This approach would promote industrial adjustment and retain the regional incentive aspect of the program. Any one of these options could be used to achieve a phased reduction in DRIE spending of up to $500 million by fiscal 1988.

Transportation

Planned spending on transportation policy of $3.8 billion in fiscal 1985 is second only to energy in total ERD spending. The Department of Transport and associated agencies has a larger compensation bill, higher operating costs, and greater capital expenditures than any other Ministry within the ERD category. It is responsible for the operation and regulation of Canada's air, marine, and rail transportation systems.

The appropriate role of transportation policy has been a subject of debate since Canada's inception. Two views dominate the debate.[18] The traditional view is that transportation policy is a major instrument of nation-building and of federal involvement in the economy and, as such, should respond to the government's growth, stabilization, and redistribution objectives. The opposing view is that transportation policy should encourage competition between the alternate modes of air, marine, and surface transport and increase the transportation sector's capacity to meet the needs of the economy without a high degree of government intervention.

Adoption of the latter view advances an important option for reducing federal spending on transportation. There is considerable scope for increased reliance on user charges for federal transportation facilities and services. Increased user charges could reduce federal funding of the operating deficits and capital requirements of federally-operated or -regulated transportation companies.

Major transportation subsidies include $680 million to VIA Rail to cover operating deficits on passenger rail services; $475 million paid by the Canadian Transport Commission to regional air carriers, truckers, and railway companies: $310 million in railway grants to support the grain shipment network; and $165 million to CN Marine to cover the operating deficits of federal ferry services. According to some analysts, the rapid growth of subsidies and operating costs has squeezed spending

[18] J.W. Langford, "Transport Canada and the Transport Ministry: The Attempt to Retreat to Basics," in Doern, p. 150.

on capital projects, training, research and development, and safety.[19]

Reductions in transport spending could be achieved by a combination of capping or cutting subsidies and increasing user fees. The federal initiative on the Crow Rate in 1983 was directed toward capping this subsidy and providing more funds to capital spending on western rail development. A new passenger rail policy, adopted in 1981, aimed to reduce VIA Rail subsidies. Public resistance to cutbacks in service may force the resort to increased passenger rail fares to achieve this objective. Other options include capping Atlantic freight rate subsidies and cutting ferry subsidies through service reductions, increased fares, and cost-sharing agreements with the provinces. Increased user fees have been recommended for airport, Coast Guard, National Harbours Board, and St. Lawrence Seaway charges. Adopting a combination of these measures could achieve target expenditure savings of $300 million by fiscal 1988.

Agriculture

Canada has a long history of government involvement in agriculture. Government policies toward land settlement, transportation, and grain exports have influenced the farm sector since before Confederation. In the depression of the 1930s, governments supported farm income maintenance by promoting marketing boards and by providing agricultural relief and rehabilitation programs. Still, direct government aid remained limited until the 1950s and 1960s, when price instability and excess capacity led governments deeply into price and income supports and direct market management. The result has been the expansion of marketing boards, price supports, farm income stabilization programs, and trade controls.

Increased government intervention served a useful purpose during this period of increased mechanization and productivity in agriculture. Farm programs eased the transition from a rural to an urban society. Employment in agriculture declined rapidly as a proportion of total employment and farm programs eased the adjustment. Today, agriculture has become industrialized. There are fewer farms, and they are larger and more specialized. The industry has become less distinctive as it has modernized. Yet it continues to obtain special attention in government policy.

Planned expenditures of $1.8 billion in fiscal 1985 reflect the government's commitment to, and intervention in, this system. Direct com-

[19]Ibid., p. 163.

modity subsidies, storage and freight assistance, subsidized crop insurance, and low-interest loans account for almost 60 percent of federal spending in this sector. Direct government payments on commodity programs and input and marketing subsidies averaged 24 percent of the aggregate realized net income of Canadian farmers in the 1970-78 period.[20]

Most federal agriculture programs have both an income stabilization and an income transfer component. A major study on government intervention in Canadian agriculture noted,

> The efficacy of "pure" stabilization policies cannot be readily measured since all stabilization programs directly or indirectly entail income transfer to farmers. Indeed it may be questioned whether there would be demand for stabilization programs if the transfer element were removed. What is more pertinent and worrisome is that income transfer programs have been justified under the rubric of "stabilization" in ways that discourage or obfuscate public debate about the legitimacy of the transfer component.[21]

Some price support programs, such as the milk subsidy, have been introduced to manage the adjustment process in a situation of persistent excess capacity. Adjustment has taken place in the dairy industry but at a more socially acceptable rate than the exodus that might have occurred without price supports. The cost, however, to consumers who pay higher prices and to taxpayers who fund the regulation of the industrial milk market has been estimated at over $1 billion in 1980.[22]

This discussion suggests one clear option for cutting federal agriculture spending. The income transfer portion of some farm programs could be reduced by redesigning the programs to emphasize income stabilization. This has already been done in the *Western Grain Stabilization Act*, which is a voluntary, contributory program. Producers' payments into the stabilization fund provide them with protection against low prices and sharp drops in income. Grain producers who value income stability have contributed to the cost of stabilization programs. If other farm income stabilization and insurance programs were made self-financing by raising producers' contributions, farm incomes could be stabilized and industry rationalization encouraged. Redesign of farm programs would involve systematic reductions in long-standing, costly price supports. This change in emphasis in farm programs could

[20] J.D. Forbes et al., *Economic Intervention and Regulation in Canadian Agriculture* (Ottawa: Supply and Services Canada, 1982), p. 13.

[21] Ibid., p. 41.

[22] Ibid., p. 58.

yield expenditure savings of $300 million by fiscal 1988.

The options discussed for reducing spending growth on economic and regional development programs could result in expenditure savings of $2.5 billion by fiscal 1988. This estimate does not include the savings that would be generated by reduced personnel and operating costs associated with reduced program spending, which could add another 10 to 15 percent to total expenditure savings. Adopting these measures would involve less government direction of economic development in Canada and greater reliance upon market forces. The federal government would continue to have a major presence in providing infrastructure and in fostering economic adjustment. This change in the federal role is justified, inasmuch as existing ERD spending often thwarts attainment of economic efficiency and has failed to achieve effectively the objective of distributing economic opportunity more equally.

Defense and Foreign Affairs

Spending on national defense and foreign policy, which represents approximately 10 percent of total federal spending, has grown rapidly in recent years. This rapid growth reflects international commitments made by the government in the late 1970s.

Canada has made a commitment to NATO allies that it will increase defense spending by at least 3 percent per year after adjustment for inflation. Increased spending has been directed to the purchase of fighter aircraft, frigates for Maritime Command, military trucks, and small arms. Repair expenditures have also increased significantly, reflecting the aging state of much of Canada's defense equipment. Total defense spending has increased by almost 50 percent over the past three years and will reach $8.9 billion in fiscal 1985. For some, this increase is long overdue because the defense budget, in relation to total spending, has been consistently eroded over the past 25 years. These observers believe that the growth in defense spending has been adequate neither to meet Canada's basic defense requirements nor to make an effective contribution to NATO. Others believe that growing deficits and the need for spending restraint mean that the growth in defense spending should be more moderate.

Options for reducing the growth of defense spending include slowing the delivery of new equipment, freezing the size of the forces, and restraining military pay increases. Such measures could cut defense spending in fiscal 1988 by up to $500 million without seriously eroding the target real rate of increase of 3 percent per year.

Expenditures for external affairs and foreign aid have grown even faster than defense spending, increasing 70 percent over the past three years to $2.7 billion. Over 75 percent of the total is accounted for by Official Development Assistance (ODA). Canada has committed itself to devoting 0.5 percent of GNP to ODA by fiscal 1986, rising to 0.7 percent by the end of the decade. The World Bank reported Canadian ODA equivalent to 0.42 percent of GNP in 1982, which was above the 0.39 percent average of seventeen OECD countries.[23] Only five countries provided development assistance equal to or greater than 0.7 percent of GNP, Canada's target for 1990. Reaching that target will require Canadian development assistance to almost double in the last five years of the decade.

In the case of development assistance, the key issue is how quickly Canada should move to its ultimate target ODA level. Canada could still make significant increases in the real value of its development assistance over the next several years even if planned aid levels were scaled down by 10 percent, or $300 million, in fiscal 1988.

Social Spending

Spending to achieve social policy objectives accounts for over half of federal government outlays. Three primary objectives of social spending are to provide basic social security through income support and social insurance payments to individuals, to provide transfers to provincial governments to finance social services, and to provide direct social services through a number of federal government departments. Social spending — including all unemployment insurance benefits — is expected to reach over $50 billion in fiscal 1985 (about 12 percent of GNP) compared to $30 billion (10 percent of GNP) four years earlier.

Social spending can be divided into three major categories (shown in Table A-5): transfers to persons, transfers to the provinces, and direct social spending. Statutory transfer payments to individuals and provincial governments account for 70 percent of social spending. Personal transfers include pensions, the federal contribution to unemployment insurance, and family allowance payments. Provincial transfers include payments for health care and post-secondary education — also referred to as Established Programs Financing — and assistance to those in need and the handicapped through the Canada Assistance Plan. Direct social spending is made up of federal programs in the areas of employment and

[23]World Bank, *World Development Report, 1983* (Washington, D.C., 1983), p. 182.

training, housing, health, native people, culture, the environment, and justice and legal services. These direct spending programs, though a small portion of total social spending, amount to over $13 billion, about the same magnitude as spending on economic and regional development or defense and foreign affairs.

Much of the recent increase in social spending has been "involuntary". Outlays in "safety net" expenditures, such as unemployment insurance and social assistance, have increased greatly as a consequence of the deep recession of 1981-82. The recession also prompted discretionary increases to finance job creation programs and housing stimulus.

A host of institutional, jurisdictional, and economic considerations limit the achievement of expenditure savings on social programs. The lion's share of social spending is on statutory transfer programs to individuals and provincial governments. Changing these programs is a major task that can take several years. Federal transfers to the provinces are negotiated by the two levels of government every five years. In the interim, there is little room for discretionary action by the federal government. Transfers to individuals represent part of the social contract in Canada, meaning that major program changes must be thoroughly debated before action is taken. Yet the federal government does exercise discretion in making year-to-year structural changes in personal transfers such as the family allowance, unemployment insurance, and old age pensions. These structural changes can have a significant impact on federal spending.

Another constraint on cutting social spending is the high level of unemployment that is expected to persist in Canada for several more years. The emergence of new labor-saving technologies and stiff foreign competition means that retraining and relocation of Canadian workers will be an important priority of social and economic policy. A well-functioning safety net can reduce resistance to necessary economic adjustment and result in a more efficient and dynamic economy.

The analysis that follows focuses on areas of social spending in which the federal government has sufficient discretion to make a meaningful contribution to deficit reduction by fiscal 1988. Federal transfers to the provinces account for 30 percent of social spending, but the need for federal-provincial consensus effectively limits the scope for unilateral action by the federal government. The government has already significantly restrained health and education transfers in the Established Programs Financing (EPF) agreements negotiated with the provinces in 1982 for

the period through 1987. While improvements in the design of federal transfers to the provinces to finance social assistance under the Canada Assistance Plan may be warranted, such changes should not seek to cut spending in the current environment of high unemployment.

The sections that follow also examine the other major areas of social spending — unemployment insurance, pensions, family allowances, and direct social spending. Table 4 summarizes potential expenditure savings. Options for reducing spending growth in these areas focus on measures that would improve program effectiveness. The adequacy and effectiveness of the social safety net could be enhanced at a lower total cost if net benefits were more closely related to the incomes of recipients. Spending could also be reduced if programs were redesigned to reduce disincentives to work and the "welfare dependency" that often results. Unemployment insurance and other income maintenance programs provide benefits that nearly match what some recipients could earn from work. Thus, deficit reduction options should concentrate upon changes in eligibility and benefit structures of social programs that could achieve social and economic objectives at reduced levels of federal spending.

TABLE 4

Options for Reducing Social Spending, fiscal year 1988

Option	Potential expenditure savings ($ millions)
Introduce experience rating for UI financing; cut federal contribution to 10 percent of program cost	1,200
Reduce net benefits to upper-income pensioners	500-1,500
Reduce net family assistance benefits to upper-income families	1,000
Cut direct social spending	500

Source: C.D. Howe Institute.

Transfers to the Provinces

Federal payments to the provinces under statutory programs are expected to be $11.2 billion in fiscal 1985, or 11.7 percent of federal outlays. This total is composed of $5.6 billion for hospital insurance, medical care, and extended health care; $1.9 billion for post-secondary education; and $3.7 billion allocated under the Canada Assistance Plan to cover 50 percent of the cost of provincial programs that deliver social, child support, and other family services. These federal transfers to the provinces are negotiated by the two levels of government every five

years, with the most recent agreement running from 1982 to 1987. The federal government can modify the arrangements without provincial consent, as it did in 1982 when transfers for health and education were capped under the federal "6 and 5" restraint program. Complete termination of the agreements, however, requires three years notice. While the federal government can act unilaterally to alter transfers to the provinces, there are real institutional constraints to making major program changes. As Thomas Courchene has recently pointed out,

> Reworking intergovernmental finances always has been and always will be an enormously difficult process since what is at stake is the distribution of money and power in the federation.[24]

In spite of this difficulty, options for changing the transfer system are continuously under review. The main issues tend to focus on the questions of federal-provincial fiscal balance and national standards for social services. In recent years, large federal deficits have existed alongside provincial budgets that were in near-balance or in surplus. This situation of fiscal imbalance led the federal government in 1981 to revise EPF transfers in order to reduce the federal commitment by approximately $1 billion annually.[25] The reduced transfers to the provinces were offset by measures that broadened the income tax base and thereby increased provincial revenue.

Federal transfers for social programs have in the past been conditional upon the provinces meeting national standards for social services. In 1981, the Minister of Finance proposed that national standards for health care be clarified and an effective mechanism for maintaining these standards be developed. The minister also called for new federal-provincial arrangements for financing post-secondary education and human resource development. The federal government subsequently introduced the *Canada Health Act* to clarify national health standards. The *Act* represents an attempt by the federal government to use its existing funding of health care as a leverage to place conditions on the delivery of health care by the provinces. In particular, the *Act* enforces universality of access to health care and, by reducing transfers on a dollar-for-dollar basis, penalizes provinces that allow extra-billing by

[24]Thomas J. Courchene, "The Fiscal Arrangements: Focus on 1987" (Paper presented to the Ontario Economic Council Conference, "Ottawa and the Provinces: The Distribution of Money and Power," Toronto, 14-15 May 1984), p. 3.

[25]Department of Finance, *Fiscal Arrangements in the Eighties: Proposals of the Government of Canada* (Ottawa, November 1981), p. 50.

physicians. The *Act* has been criticized on the grounds that it limits the flexibility of provincial governments to undertake experimentation and innovation to improve efficiency in the delivery of health care.[26] Regardless of one's assessment of the *Act*, however, it is clear that its central concern was not federal fiscal restraint. The federal government's desire to reassert its role in setting national standards limits its options for reducing health care transfers.

New financing arrangements for post-secondary education have yet to emerge. One suggestion for easing the squeeze on post-secondary education is that provinces move toward raising the share of funding that comes from tuition fees.[27] In order to ensure equality of access to post-secondary education, higher tuition fees would have to be offset by increased funding of student loans. To achieve this, the federal government could withdraw its cash transfer to the provinces for post-secondary education and use these funds for student loans. The initial impact on federal spending would be small but, as loans begin to be repaid in subsequent years, budgetary savings could be large. One consequence of this approach, however, might be to limit the federal government's ability to set national standards for post-secondary education.

The third major federal-provincial transfer is for social assistance under the 50 percent cost-shared Canada Assistance Plan. To encourage expenditures on welfare, the federal government matches every dollar spent on qualifying programs undertaken and delivered by the provinces. One problem with this system is that the poorest provinces — and, consequently, those that have the greatest demand for social assistance — have the least capacity to raise the provincial dollars needed to obtain federal cost-sharing. Another problem is that, for the wealthier provinces, the availability of unconditional cost-sharing reduces the incentive to experiment with potentially more-efficient methods of delivering social assistance. The large increase in unemployment since 1981 has exacerbated the strains on the social welfare system and has swollen the welfare roles with thousands of people, many of them under 30 years of age, who are capable of working but cannot find jobs. In this environment,

[26]Courchene, "The Fiscal Arrangements," pp. 7-8.

[27]See Jonathan R. Kesselman, "An Alternative Approach to University Financing: Student Tuition and Contingent Repayment Loan Policies" (Paper presented to Symposium on "University Accessibility in a Period of Financial Restraint," University of British Columbia, 5 November 1983); Courchene, "The Fiscal Arrangements," p. 8; and Claude Ryan, "Federal Transfer Payments: A Quebec Perspective" (Paper presented to the Ontario Economic Council Conference, "Ottawa and the Provinces: The Distribution of Money and Power," Toronto, 14-15 May 1984), pp. 20-23.

changes need to be made to social assistance in order to increase flexibility and effectiveness, but such changes probably should not be expected to generate savings for the federal government.

Although the federal government has the legal right to unilaterally alter provincial transfers, and although options exist for reducing federal expenditures, the scope for major unilateral changes in these programs as a means of reducing the federal deficit is limited. As Claude Ryan has recently argued,

> Transfer payments have been very useful in the past. They are indispensable today, and they will still be necessary in the future. However, transfer payments must be prevented from... creating between the provinces and the central government a dependence relationship contrary to the spirit and letter of the Canadian Constitution. It is therefore extremely important that the design and implementation of transfer payments be the subject of a dialogue in good faith between the governments concerned, prior to any final decision on the matter.[28]

Because of the need for federal-provincial negotiation and consensus on these issues, no specific estimates of potential expenditure savings on provincial transfers are presented here.

Unemployment Insurance

Unemployment insurance (UI) plays a key role as a safety net and stabilizing force in the economy. At the same time, the present system distorts labor market behavior by encouraging short-term labor force attachment and seasonal employment. In some parts of the country, it is possible to work for 10 weeks and collect UI for the rest of the year. The result is that the system encourages dependence on UI and contributes to high unemployment.[29]

Even though unemployment is likely to remain high for several more years, options that could remove perverse incentives, improve the working of the labor market, and reduce UI benefits should be considered.

Benefits paid to the unemployed are expected to reach $11.6 billion in fiscal 1985, almost double the level of 3 years earlier. The federal govern-

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[28]Ryan, pp. 27-28.

[29]For a discussion of the adverse influence of UI on labor market behavior, see R. Boadway and H. Kitchen, *Canadian Tax Policy*, Canadian Tax Paper no. 63 (Toronto: Canadian Tax Foundation, 1980), pp. 237-248; and Jonathan Kesselman, *Financing Canadian Unemployment Insurance*, Canadian Tax Paper no. 73 (Toronto: Canadian Tax Foundation, 1983), pp. 18-30.

ment will collect premiums of $8.4 billion from employers and employees; it will contribute $2.7 billion to the UI fund from general revenues to cover the cost of regional extended benefits and net benefits paid to fishermen. A deficit of $500 million in the UI fund will be covered by a loan to the fund from the federal government. The federal government's contribution will make up 27 percent of the program's total cost in fiscal 1985.

Under the present system, individuals are eligible to receive one week of UI benefits for each week of employment, up to 25 weeks of eligibility (Phase I), and then one week of benefits for each two weeks of employment above the first 25 weeks, up to 13 additional weeks of eligibility (Phase II). Regional extended benefits augment the regular benefits by 2 to 32 benefit weeks, depending on the regional unemployment rate. The maximum entitlement is 50 weeks in any 52-week period.

The present system has two serious shortcomings. First, since UI eligibility is accumulated more quickly in the first 26 weeks of employment, the Phase I and II eligibility rules encourage short-term employment. Second, the present system's uniform premium structure has the effect of creating a subsidy for workers and firms that have seasonal or unstable employment patterns.

Jonathan Kesselman of the University of British Columbia has recently proposed major changes in UI that would eliminate these flaws and greatly reduce the cost of the program.[30] To reduce the incentive to short-term employment, eligibility for UI benefits could be accumulated at a rate of one week of benefits for each three weeks of insured employment over the previous three years. Those individuals with longer-term attachments to the labor force would receive the same benefits as under the existing system. Coverage would be reduced for short-term or erratic spells of work and fewer individuals would be induced to accept unstable employment in order to qualify for UI benefits.

Kesselman also proposes the elimination of regional extended benefits and the implementation of "experience rating" in the system of financing unemployment insurance. Under pure benefit taxation, individuals would pay UI premiums directly related to the risk of unemployment, based on past experience in their industry and occupation. Experience rating would achieve this principle by relating premiums to the risk of unemployment in individual firms. Kesselman notes that,

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[30]See Jonathan Kesselman, "Less Insurance, More Jobs," *Policy Options*, (May-June 1984), pp. 45-47.

> if employer premiums were experience-rated, a large part of these...costs [of regional extended benefits currently paid by the federal government] could be assigned to the private sector. These benefits reflect the higher unemployment costs attributable to industries and firms with above-average seasonal and cyclical unemployment risks. If these costs could be assigned to the particular industries or firms, this would promote overall economic efficiency and program equity in the benefit-taxation sense.[31]

Kesselman also proposes several other reforms, including ending the use of UI funds to finance work-sharing and major reductions in special UI benefits for severance and maternity. He estimates that adoption of these reforms could reduce UI costs by 30-40 percent or $3.5-5 billion at recent annual rates.[32]

Retaining some role for the federal government in financing UI is important if the stabilization properties of the system are to be maintained. Federal contributions should be higher in periods of high unemployment. As the economy approaches full employment, however, the federal share could be reduced. The size of the actual savings from Kesselman's proposals would be determined by many factors, including offsetting expenditures to increase employment incentives, the impact of the changes on the level of unemployment, and the proportion of total program costs to be contributed by the federal government. If the net effect of the changes were to reduce the unemployment rate by 1 percentage point and the federal contribution to 10 percent of total program costs, savings of approximately $1.2 billion could be achieved in fiscal 1988.

Pensions

The Old Age Security (OAS) program, which pays a basic pension to all those 65 years of age and over, provides older Canadians with a guaranteed minimum income. In fiscal 1985, OAS benefits of $8.3 billion will be paid to approximately 2.5 million pensioners. Over half of these people will also receive a total of $2.7 billion in Guaranteed Income Supplement (GIS) payments to bring their income up to a guaranteed minimum level.

Public pensions transfer income from the current working generation to the retired. The OAS is a universal program; it is not related to the income of the recipient. All those over age 65 receive OAS regardless of

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[31]Kesselman, *Financing Canadian Unemployment Insurance*, p. 75.

[32]Kesselman, "Less Insurance, More Jobs," p. 46.

how much they receive from other sources. The GIS, on the other hand, is an income-tested supplement to the OAS that provides a minimum income for low-income pensioners.

The guaranteed minimum pension income could be provided at a lower total cost if OAS/GIS were revised by reducing the lump sum universal pension benefit provided by OAS and by increasing the income-related GIS portion. The present combined OAS/GIS assures single pensioners of a minimum income of $7,200 per year, based upon OAS payments of $3,400 and GIS payments of $3,800. The GIS is reduced for income in addition to the guaranteed minimum by $1 for every full $2 per month of additional income. Thus, a pensioner whose income from sources other than the OAS/GIS comes to twice the amount or more of the GIS — that is, $7,600 or more — receives no GIS benefit, but continues to receive the OAS for a total gross income of $11,000 per year. Estimates based on the family income survey conducted by Statistics Canada indicate that families earning incomes exceeding $23,200 receive $1.5 billion in OAS payments.[33] Some economists argue that the undiscriminating OAS has outlived its usefulness and should be replaced entirely by an expanded GIS.[34] An expanded GIS that guaranteed the same minimum income as the existing OAS/GIS could create considerable savings for the federal government. The Economic Council of Canada has estimated that in 1979, when combined OAS/GIS payments were $6.2 billion, such a change would have reduced expenditures by $1 billion while maintaining the same guaranteed minimum income level.[35]

The difficulty with an expanded GIS is that it would reduce the incomes not only of upper-income pensioners but also of any pensioner whose income exceeded $11,000. An alternative approach would be to continue the OAS in its present form but to introduce an escalating tax-back of OAS benefits for single pensioners with incomes above $15,000 or couples with incomes exceeding $25,000. The savings from this approach would be smaller — perhaps $500 million to $1 billion by fiscal 1988 — but the negative impact on middle-income pensioners would be reduced.

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[33]Michael Walker, "Deficit Benefit in Biting Bullet on Universality," *Financial Post*, 21 April 1984, p. 8.

[34]This view was expressed by Dr. Peter H. Pearse in a dissenting comment in Economic Council of Canada, *One in Three: Pensions for Canadians to 2030* (Ottawa: Supply and Services Canada, 1979), p. 113.

[35]Ibid., p. 40.

A serious concern about reducing federal pension spending is that it would be unfair to those who have based their retirement savings decisions on the assumption that the OAS would continue in its present form. Reducing universal pension benefits for middle- and upper-income groups who have paid taxes and who expect to receive pension benefits would mean modifying an important part of the social contract in Canada. Thus, any change in universal pension benefits should be gradually phased in. Nevertheless, there is a growing awareness that public pensions are financed not out of past contributions but, rather, out of taxes on today's working population. The viability of the system, therefore, relies on the perception that both the workers who pay taxes and the elderly who receive benefits are treated fairly.

The Family Allowance

The federal government will pay $2.7 billion in family allowance benefits in fiscal 1985. The family allowance is, like the OAS, a universal transfer program paid to mothers of dependent children. The family allowance is one part of Canada's family income security system, which also includes the dependent child deduction under the personal income tax — valued at $900 million in fiscal 1984 — and the income-related refundable child tax credit — valued at $1.4 billion.

Ever since the federal government introduced a proposal for a comprehensive Family Income Security Plan (FISP) in 1971, there has been an ongoing debate about the design and interaction of the various family income support mechanisms. The FISP proposed a more selective approach that would have involved maximum payments for those with low incomes, diminishing to zero as income increased. It was never enacted. Instead, there was piecemeal reform. Some reforms, such as making family allowance payments taxable and the introduction of the refundable child tax credit, have made the system more selective. Others, such as the indexation of the family allowance, have maintained the universal nature of family programs.

The purpose of family income security is to provide basic support to Canadian families, particularly those in greatest need. This support, however, is not geared closely to family income. The family allowance is granted to all families with children. The dependent child deduction benefits taxpayers in proportion to their tax-rate bracket, providing high-income families with the greatest support. The refundable child tax credit declines as family income rises, but the net effect of the three pro-

grams is to provide maximum beneifts to upper-middle-income families.[36]

The federal government could achieve considerable expenditure savings by relating these programs more closely to family income. One option would be to replace the family allowance and the dependent child deduction with an enriched refundable child tax credit program. A reform of this type could reduce the federal deficit by $1 billion without reducing benefits to low- and lower-middle-income families. There are a number of problems with such a change, however. First, because the family allowance is paid to women, the elimination of this highly visible transfer could be seen as placing an unfair burden of deficit reduction upon women and their families. Second, a drawback of the refundable tax credit is that some low-income families do not file income tax returns and, therefore, could receive no benefits at all. Third, institutionalized orphans, although they receive the family allowance, are excluded from the child tax credit since there is no parental income. Fourth, the child tax credit is refunded once a year in a lump sum, thus increasing budgeting problems for low-income families. Furthermore, the tax refund cheques are assignable, so they can end up in the hand of tax discounters. Fifth, the use of joint parental income makes mothers more dependent on their spouse for child benefits. Finally, the tax credit is slow to respond to major changes in a family's income. For example, if a high-income family member becomes unemployed it can take over a year before the family receives a tax credit that reflects its new lower-income status.

An alternative would be to eliminate both the child tax exemption and the refundable child tax credit and replace them with increased family allowance payments that would be subject to an escalating tax-back of benefits.[37] This approach would overcome the major problems associated with the expanded child tax credit. An expanded family allowance could be targeted to low-income families by a carefully designed tax recovery scheme. Such a scheme would maintain the net family benefits currently available to lower-income families but significantly reduce such benefits to families with incomes over $25,000 per year.

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[36]See Boadway and Kitchen, pp. 271-273; and Ernie S. Lightman, "Canada's Tax System and the Poor" (Background Paper and Pre-Budget Submission to the Minister of Finance, prepared on behalf of the National Anti-Poverty Organization, Ottawa, January 1984), pp. 52-65.

[37]See Jonathan Kesselman, "Pitfalls of Selectivity in Income Security Programs," *Canadian Taxation* 2 (Fall 1980): 162.

Other Social Expenditures

Social spending, aside from the major statutory transfer programs, will amount to $13.5 billion in fiscal 1985. Major areas of spending include support of arts and culture, direct job creation, training and other employment services, environmental protection, native people's programs, housing programs, veterans affairs, and the operation of the justice and legal system (see Table A-6).

Over half of direct social spending is made up of compensation of federal employees and other operating expenditures. About 40 percent of the total is accounted for by grants and transfers to individuals, other levels of government, and social service organizations (see Table A-7). The largest of these grants include $900 million to cover the operating deficit and capital costs of the Canadian Broadcasting Corporation; $1.1 billion in direct job creation and training grants: $1.4 billion paid to native people and territorial governments; $1 billion in housing assistance; and $1.2 billion in veterans support and pension programs.

Control of this large part of federal expenditures could be achieved by general restraint measures applied to compensation and operating expenses and by reducing transfers in lower-priority areas. Expenditures on direct job creation peaked in fiscal 1984 and should decline as the recovery continues. The federal government has an important role to play, however, in promoting labor market adjustment. Government assistance for training and improved labor market information should continue to be accorded high priority.

Federal housing assistance should be carefully scrutinized. The $1 billion in housing grants is only a small part of total federal assistance to the housing sector, which includes several important tax provisions and was estimated to be $7.2 billion in 1983. Most of the direct grants support low-income, rural, or native housing development. Programs such as those that support housing cooperatives and subsidize home renovations encourage alternative housing patterns and create jobs, but could be better targeted to ensure that they benefit low-income families. These programs should be critically reviewed in conjunction with an assessment of housing tax incentives that tend to provide the greatest benefits to upper-income groups.

Decisions to cut direct social spending boil down to difficult tradeoffs. Should the $900 million grant to the CBC be reduced? Are there ways of increasing the efficiency of security services provided by the RCMP or correctional services provided by the Solicitor General? Can Canada afford to spend less on environmental programs, on medical

research, or on official languages, training, ethnic, and women's programs? In some of these areas, there exist sound arguments for expanding, rather than restraining, federal spending. Nevertheless, restraining the growth of such programs, which will account for $15 billion in federal spending in fiscal 1988, could yield expenditure savings of between $500 million and $1 billion.

The options discussed in this section represent methods of improving the effectiveness of social programs to limit their cost. If all were adopted, federal spending on social development would be reduced by about $4 billion compared to currently planned levels. These programs must be evaluated continually to ensure that the services they provide meet important public objectives as efficiently as possible.

Summary

It is clear from the preceding discussion that a number of options exist for reducing federal spending. Increasing efficiency, restraining compensation, raising user fees, and selling crown corporations are means of reducing spending without cutting programs. While the scope for increasing efficiency is unknown, it does not appear, however, that the other measures could provide more than $2-3 billion in expenditure reductions by fiscal 1988. This implies that any attempt to reduce the federal deficit significantly by cutting planned spending will require cuts in major government programs.

The options for program cuts are based on the notion that program changes that would better achieve economic and social objectives at lower levels of spending are superior to straight proportional cutbacks in existing spending programs. This chapter has identified options for reducing planned spending in three areas: economic and regional development, defense and foreign policy, and social programs, which would result in program expenditure savings of over $8 billion. Lower interest payments associated with slower growth in federal debt could contribute another $2 billion in savings. Achieving the target deficit reduction of $11 billion by fiscal 1988 could be achieved almost entirely on the expenditure side of the budget. It could only be achieved, however, if measures are taken to reduce federal spending of all types, including social spending.

Canadian society would be changed by the adoption of these options to slow the growth of federal spending. Canadians would have to learn to become more self-reliant and to look less to government for assistance

and subsidies. Spending commitments by the federal government would have to be geared more closely to taxpayers' willingness and ability to pay for public services.

The corporate sector would be forced to make decisions more on the basis of market incentives and less on the basis of government guarantees and subsidies. If the reduced level of government involvement in economic development was accomplished both by a reduction in the regulation of business and by improvements in the functioning of markets, however, the corporate sector could obtain significant long-term benefits.

Reducing the growth of spending on national defense and foreign development assistance would require Canada to reduce commitments made in better times. Some cuts in planned spending levels could be made in these areas, however, while still increasing real expenditures.

Finally, if the deficit is to be reduced to reach the 1 percent of GNP target by fiscal 1988, and if this is to be done without raising taxes, some cuts in social spending are unavoidable. If social spending must be cut, attention should focus upon programs that are poorly targeted and, therefore, that achieve minimum objectives only at high levels of spending. Programs such as unemployment insurance, the old age pension, and the family allowance could all achieve their basic social objectives at lower cost and with no loss of benefits to low-income groups if the expenditure and tax systems were redesigned to make them more carefully targeted. Adopting such changes could mean a change in the basic philosophy of social spending. Canadians' sense of entitlement to government assistance regardless of one's financial position would be increasingly challenged.

The popular notion among Canadians that government spending could be easily and painlessly reduced by cutting public-sector jobs and wages is inaccurate and diverts discussion from the true nature of the choices that will have to be made. If the deficit is to be reduced, Canadians must choose between reduced government services and increased taxes to finance existing programs. A new vision of the role of government and its interaction with the private sector will be required if a major portion of deficit reduction is to come from lower spending growth. That vision has not yet developed in Canada.

3

Raising Federal Revenue

If Canadians are unwilling or unable to bring about significant reductions in planned federal spending, they are faced with only one alternative for reducing the deficit: federal tax revenues will have to rise. Three basic options exist for accelerating revenue growth: tax rates could be increased, existing tax bases could be broadened by reducing tax expenditures, or new taxes could be introduced. Indeed, the existence of large deficits has already brought about in recent budgets a variety of revenue-raising measures, not all of which have generated the desired results. Although the recession interrupted the quest for higher revenues, the federal government did adopt a strategy in its April 1983 budget that included both increases in tax rates and the elimination of certain tax expenditures. These measures were designed to increase federal revenues by $3 billion by fiscal 1987.

This strategy will push federal revenues as a percentage of GNP well above their historical average. Total federal revenues (shown in Figure 5) are expected to increase to 20 percent of GNP by the end of the government's fiscal plan, well above the average of the 1960s (17 percent) or the 1970s (18.5 percent).[1] Even with this increase, the federal deficit is expected to remain high. Additional revenue-raising measures may be needed to reduce the deficit. If this option is chosen, it implies a willingness by Canadians to accept an increased role for the federal government in the national economy and an increased tax burden to finance that role.

This chapter analyzes the three basic revenue-raising options. Achieving the entire deficit reduction target of $11 billion on the revenue side of the budget, though possible, would be politically difficult and damaging to the prospects for recovery in the private sector. If an $11 billion increase in taxes by fiscal 1988 was distributed in the same way as the existing load, individuals would be called on to pay an additional $8 billion

[1]Department of Finance, *The Fiscal Plan* (Ottawa, February 1984), p. 63.

in personal taxes. Approximately six million middle-income taxpayers, who would bear most of the burden, would face an average tax increase of about $1,000 per year.

If Canadians accept as necessary tax increases of this magnitude, the issue of fairness in distributing the increased tax burden will become paramount. The economic consequences of tax increases, however, do not end with the distributional effects. Each option for raising revenues would have different consequences for economic growth and for efficiency in the allocation of resources. The need to reduce the deficit, therefore, presents policymakers with a tough challenge to find ways to spread the higher tax burden in a manner that is perceived as fair and that encourages investment and job creation.

Major Federal Revenue Sources

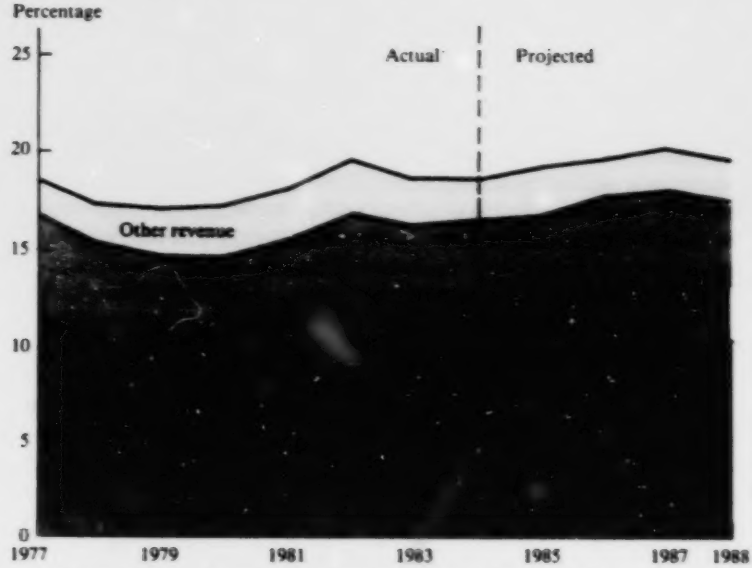
The largest elements in the federal revenue structure, shown in Table A-8, are personal income taxes (currently about 40 percent of the total), corporate income taxes (12 percent), and social insurance premiums (12 percent). Other important sources of federal revenue include excise taxes, energy taxes, and investment income. The trend of the early 1980s has been toward increased reliance on personal income taxes and energy taxes, offset by reduced contributions from corporate income taxes. These trends reflect both the sharp drop in corporate profits that occurred during the 1981-82 recession and the thrust of recent federal budgets.

Personal income tax is payable on money income from most sources. The federal government broadened the tax base in the 1970s by including one-half of all capital gains, unemployment insurance benefits, and family allowances. While these inclusions signaled a move toward a broader definition of income, a variety of personal tax exemptions, deductions, and tax credits still reduce the tax base. The indexation of personal exemptions and tax brackets in 1974 by an inflation factor based on the Consumer Price Index had the important effect of reducing the automatic tendency of revenues to rise in periods of rapid inflation. The government partially deindexed the system in 1982 when, as part of the "6 and 5" program, it set the indexing factor at 6 percent for 1983 and 5 percent for 1984. The budget of February 1984 restored full indexing.

Corporate income taxes have declined in importance as a source of federal revenue. The drop in corporate profits is partly responsible, but the proliferation of corporate tax incentives has also been an important factor. The corporate tax is levied at a rate of 46 percent on business in-

FIGURE 5

Federal Government Revenue, fiscal years 1977-88
(percentage of GNP)



Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1984).

come. As an incentive to small business, a low rate of 25 percent applies to the first $200,000 of business income of Canadian-controlled private corporations. A special rate of 40 percent applies to manufacturing and processing profits earned in Canada. A number of corporate tax provisions, such as accelerated depreciation of certain assets and investment tax credits, reduce the corporate tax base. The April 1983 budget expanded investment tax credits.

Energy taxes have increased in importance as a source of federal revenue since the introduction of the National Energy Program (NEP) in October 1980. The Petroleum and Gas Revenue Tax (PGRT) accounts for over 60 percent of federal energy revenue.

The PGRT is levied at an effective rate of 12 percent on net revenue, rather than on net profits as in the case of the corporate income tax. No deductions are allowed for depletion, depreciation, exploration and development expenses, interest expenses, or a number of other deduc-

tions allowed under the corporate income tax.[2] By not allowing these items as deductions, the PGRT greatly broadened the base to which the tax applies, thereby significantly increasing its yield. The drawback of such a tax, of course, is that it is inflexible with respect to changing costs and net profits of the petroleum industry and, therefore, can act as a significant deterrent to exploration, development, and production of new oil and gas.

Three other important federal energy taxes are the Petroleum Compensation Charge, levied on all crude oil as part of a system designed to maintain a uniform crude oil price below the world price; the Oil Export Charge, levied on all oil exports at a rate equivalent to the difference between the average wellhead price of oil in Canada and the world price; and the Canadian Ownership Special Charge, levied on petroleum produced or consumed in Canada, the proceeds of which were originally intended to finance increases in federal ownership of the oil and gas industry.

Contributions to government pension plans and unemployment insurance (UI) account for one-eighth of federal revenues. Employer and employee UI contributions reached $7.5 billion in fiscal 1984. The employee contribution rate is 2.3 percent of insurable earnings, up to a maximum of $385 per week; employer contributions are 1.4 times the employee rate, or 3.22 percent. Revenue Canada collects these premiums as payroll taxes, with the proceeds flowing into the federal government's special UI fund. The fund is expected to be self-financing, so premiums are adjusted to eliminate any deficit or surplus in the account over a period of several years. The large increase in unemployment in the 1981-82 recession created a sharp increase in the cumulative deficit of the UI fund, which is expected to reach $5 billion in fiscal 1985.[3] The federal government makes up any short-fall of UI revenues by loans to the UI fund. As unemployment declines in the future, premium revenues are expected to exceed benefit payments, which will allow the cumulative deficit to decline.

The federal sales tax applies to most manufactured goods produced in Canada or imported. The general tax rate is 9 percent, with special rates of 12 percent on tobacco and alcohol products and 5 percent on building materials. A Special Recovery Tax, announced in the April 1983 budget, is scheduled to increase each of these rates by 1 percentage point on 1 October 1984. The manufacturers' sales tax exempts a wide list of products,

[2]Canadian Tax Foundation, *The National Finances 1982-83* (Toronto, 1983), p. 96.
[3]Department of Finance, *The Fiscal Plan*, pp. 33-34.

the most important being food and nonalcoholic beverages and electricity and fuels.

The remainder of federal revenue accrues from a variety of sources, including investment income made up of interest and remitted profits of crown agencies, various excise taxes, customs duties, nonresident withholding taxes, and various user fees, licences, and proceeds from sales.

Revenue-Raising Strategies

Cutting the deficit by raising taxes will not be an easy task; there is no painless way of going about it. Nevertheless, reducing the deficit and the public debt provides a straightforward and well-understood rationale for some tax increases. Public reaction to measures to increase federal revenues will depend very much on their impact on economic recovery, the sense that further expenditure reductions are not an appropriate alternative, and the burden imposed on specific groups of individuals or industries.

Canada is still emerging from its most serious postwar recession. Personal disposal income growth has been weak in the early stages of the recovery and the business sector has been using improved profits to rebuild its badly damaged financial position. Thus, any future tax increases should be phased in to take effect as economic expansion is more firmly in place. This argument should not be used, however, to delay action. Credible steps to reduce the deficit would boost confidence in the private sector and provide scope for modest interest rate reductions that would strengthen the recovery. Advance notice of the timing of tax increases would give individuals and business planners warning of how conditions will change and provide a positive signal to financial markets about the future course of the deficit.

Any desired increase in revenue will have to be achieved by some combination of increasing tax rates, broadening existing tax bases, and creating entirely new tax bases. The first option would involve an attempt to generate more revenue from the existing tax system. To the extent that the current system is inequitable or distorts economic decisions, these flaws would become more pronounced if tax rates were increased. Measures to raise revenues should be designed, where possible, to reduce, rather than exacerbate, flaws in the current system.[4]

[4]For excellent discussions of Canadian tax policy issues, see R.W. Boadway and H.M. Kitchen, *Canadian Tax Policy*, Canadian Tax Paper no. 63 (Toronto: Canadian Tax Foundation, 1980); and W.R. Thirsk and J. Whalley, eds., *Tax Policy Options in the 1980s*, Canadian Tax Paper no. 66 (Toronto: Canadian Tax Foundation, 1982).

The second option — broadening existing tax bases — could simplify the tax structure and improve its fairness. Broadening existing bases would be achieved by reducing the value of tax expenditures. Tax expenditures include all kinds of exemptions, deductions, and credits that reduce taxes paid by individuals and businesses. Those who advocate broadening the tax base argue that the advantages of reducing tax expenditures — aside from the obvious potential for raising revenue — are that taxpayers with equal pretax incomes would be taxed more equally, the tax system would be simplified, and unproductive efforts to avoid taxes would be reduced. In spite of these apparent benefits, tax-base broadening has proven difficult to achieve in the past, suggesting that many tax expenditures exist for sound reasons.

The November 1981 federal budget proposed to simplify the tax system and broaden the personal and corporate income tax bases by eliminating or reducing a number of special tax provisions. By expanding the tax base, the government was able to lower personal income tax rates and still raise revenues by $2 billion by fiscal 1985.[5] Stiff public resistance to the selective reduction in tax expenditures caused the federal government to back away from several of the proposed changes, however, thereby reducing the revenue gain.[6] The 1981 experience revealed the political difficulty of a piecemeal approach to broadening the tax base. Once implemented, tax expenditures prove difficult to remove, especially when this is done in the name of equity. Those who lose from such measures tend to be concentrated in specific groups of taxpayers who can often develop a convincing case for retaining specific tax provisions.

A third option for raising revenues would be to introduce an entirely new tax. Recent tax debates in the United States have concerned such possibilities as the introduction of a value-added tax to augment the present tax structure. Such a new tax would have the advantage of avoiding the negative economic effects of raising existing tax rates and the difficult political choices involved in reform of tax expenditures. Although the federal government has not exhausted the revenue capacity of existing taxes, new forms of taxation might be the most economically and politically acceptable sources of new revenue.

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[5]Department of Finance, *The Budget in More Detail* (Ottawa, November 1981), p. 50.

[6]Irwin Gillespie has estimated that political accommodation on the November 1981 tax reform proposals resulted in a federal revenue loss of 21 to 26 percent of the original increase. See W.I. Gillespie, "The 1981 Federal Budget: Muddling Through or Purposeful Tax Reform?" *Canadian Tax Journal* 31 (November-December 1983): 975.

The November 1981 experience indicates that whatever measures are adopted to raise revenues, they should be carefully reviewed to determine their impact on particular groups. One approach would be to adopt across-the-board strategies that spread the increased tax burden as widely as possible. The opposite approach would be to adopt targeted measures that would concentrate tax increases on particular groups based on their ability to pay or that would provide a means of removing structural deficiencies in the tax system that benefit particular groups. The following sections identify across-the-board and targeted options and evaluate these options on their ability to raise revenue and their implications for economic efficiency and equity.

Specific Options for Raising Revenue

Raising Tax Rates

Increasing federal tax rates is the simplest and most straightforward across-the-board method of raising federal revenues. Tax rate increases tied to a deficit-reduction objective would be easily understood and could apply broadly to taxable individuals, corporations, or commodities. A tax rate increase could take the form of a permanent increase in basic tax rates or a temporary surtax that could be phased out in the future if better structural balance was restored. A combination of increases in personal, corporate, sales, and excise tax rates would have the advantage of spreading the burden of deficit reduction among all taxpayers.

Higher tax rates, however, could have important negative consequences. First, higher marginal tax rates encourage both legal and illegal tax avoidance. High-income individuals would be encouraged to channel more of their savings and investments into tax-sheltered activities and away from often more-productive alternatives. Second, taxpayers would be more tempted to participate in the underground economy, which would be counterproductive to the objective of raising revenue. Third, higher tax rates could increase distortions in economic activity created by the existing tax structure. To the extent that provisions in the existing tax system misallocate labor and capital resources, raising tax rates would tend to worsen this situation. Finally, increasing sales and excise tax rates would cause a one-time increase in costs and in the rate of inflation. For these reasons, many economists and tax specialists argue that tax rate increases should be used to reduce the deficit only after alternatives for

broadening the tax base have been exhausted.[7]

TABLE 5

Options for Federal Tax Rate Increases, fiscal years 1986-88

Option	Potential revenue yield ($ millions)		
	1986	1987	1988
One percent surtax on personal income tax liabilities	370	410	450
One percent surtax on corporate income tax liabilities	105	115	125
One percent increase in effective rate of PGRT	190	215	245
One percent increase in Manufacturers' Sales Tax rate	900	1,000	1,100
One cent per litre increase in Gasoline Excise Tax	280	290	295

Source: C.D. Howe Institute.

Table 5 presents estimates of the potential revenue yield from selected federal tax rate increases in fiscal 1986 through 1988. Personal and corporate tax rate increases are estimates of the yield from a 1 percent surtax on existing tax liabilities, while other options shown are increases in basic tax rates. These estimates assume no change in the tax base in response to higher tax rates. To the extent that higher tax rates cause more tax avoidance, these yields would be reduced. To achieve its revenue objectives, the federal government could phase in various tax rate increases. For example, an increase in the federal sales tax rate from 10 to 12 percent in fiscal 1986, followed by a 10 percent personal income tax surtax in 1987, and a 10 percent corporate surtax in 1988, could yield revenue increases of approximately $2 billion, $6 billion, and $8 billion in the three successive years.

Broadening the Tax Base

An alternative means of raising federal revenues would be to broaden or expand the definition of income subject to tax at the existing rates. A large number of income exclusions, tax deductions, exemptions, and tax credits narrow existing bases for personal and corporate income taxes in

[7]See, for example, Harvey Galper, "Tax Policy," in Joseph A. Pechman, ed., *Setting National Priorities: The 1984 Budget* (Washington D.C.: Brookings Institute, 1983), p. 184; and United States, Congress, Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (Washington, D.C.: U.S. Government Printing Office, 1984), p. 186.

Canada. In 1979, the federal government published for the first time official estimates of the revenue foregone because of the existence of certain tax expenditures.[8] These estimates have not been recently updated.

At first glance, the scope for increasing revenues by reducing tax expenditures appears quite large. Table 6 presents estimates of the degree to which the personal and corporate income tax bases are eroded by tax expenditures and the value of the tax reductions that they bestow. The existence of the personal and corporate tax provisions shown in Tables A-9 and A-10 reduced federal revenue by almost $20 billion in fiscal 1979. The magnitude of these tax expenditures and their apparent unsystematic evolution has led to calls for their elimination or reduction in combination with a reduction in tax rates.

TABLE 6

Impact of Personal and Corporate Tax Expenditures, fiscal year 1979
($ billions)

Impact on income subject to tax	Personal	Corporate
Income without tax preferences	156.3	43.6
Less: income subject to tax	109.0	25.2
Equals: erosion of tax base	*47.3*	*18.4*
Impact on tax payable	**Personal**	**Corporate**
Federal income tax without preferences	30.8	11.0
Less: actual federal income tax	17.0	6.6
Equals: value of tax expenditures	*13.8*	*5.4*

Sources: Department of Finance, *Analysis of Federal Tax Expenditures for Individuals* (Ottawa, November 1981), p. 1; and C.D. Howe Institute estimates for corporate tax preferences, based on Statistics Canada, *Corporation Taxation Statistics, 1980*, Cat. no. 61-208 (Ottawa, August 1983), pp. 66-67, and Department of Finance, *Government of Canada Tax Expenditure Account* (Ottawa, December 1980).

Personal Income Tax

A closer examination of these tax expenditures indicates that, in many cases, their elimination would be either difficult or unjustified. For example, of the $13.8 billion in personal tax expenditures in fiscal 1979, about $3 billion was accounted for by basic exemptions and tax credits that provide low-income relief. Another $2.6 billion of foregone revenue was the result of pension deductions, while housing-related provisions accounted for $4.5 billion of personal tax expenditures. Many economists would like to see these preferences reduced both because they

[8]Department of Finance, *Government of Canada Tax Expenditure Account* (Ottawa, December 1980).

tend to favor upper-income individuals and because they channel scarce investment resources into residential construction rather than into more-productive business investment in plant and equipment.[9] The tax treatment of housing would be difficult to alter, however; about $2 billion of foregone revenue was the result of the nontaxation of imputed rent from owner-occupied homes. This is not a form of money income and, therefore, would be extremely difficult to tax. The remainder results from the nontaxation of capital gains on a principal residence. Taxing capital gains on housing could reduce labor mobility at a time when structural changes in the economy call for more, not less, movement of people. This problem has been overcome in the United States, where capital gains on a principal residence are taxable, by allowing an exemption of realized gains if another residence is purchased within a year. If capital gains on houses were to be taxed, however, such gains should be taxed only on an inflation-adjusted basis. If these provisions were added, the revenue yield from taxing capital gains on principal residences would be significantly reduced.

Many of the other significant personal tax expenditures were implemented to correct perceived flaws in the tax system, as in the case of the dividend gross-up and tax credit, which was designed to alleviate double-taxation of dividend income, and in the exemption of the first $1,000 of investment income, which was designed to partially mitigate the taxation of interest and dividend income that merely reflects the inflationary gain on assets. Other tax expenditures were put in place to further seemingly worthwhile social objectives: the deduction of tuition fees to promote investment in education, the deduction of charitable donations, and the deduction of medical expenses. As tax specialist Joseph J. Minarik has observed,

> In sum, the tax expenditure pot, in which at first seems to run over with potential revenue for base broadening, is found to be half-filled with foam. The actual brew is no less tasty, but it is in shorter supply.[10]

Personal tax expenditures must be judged against their effectiveness in achieving their stated objectives. For example, the most basic justification of personal exemptions is that very-low-income earners have no tax-paying capacity. Thus, the basic personal exemption and the exemptions

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[9]See, for example, Patricia Fulton, "Tax Preferences for Housing: Is There a Case for Reform," in Thirsk and Whalley, pp. 73-95.

[10]J.J. Minarik, "A Flat Rate Income Tax for Canada?" in *Report of Proceedings of the Thirty-Fourth Tax Conference* (Toronto: Canadian Tax Foundation, 1983), p. 41.

for a dependent spouse or children eliminate the tax liability of low-income individuals and families. This rationale is generally accepted. It is not obvious, however, that the same rationale holds for middle- and upper-income earners as well. Exemptions available to all provide greater tax relief to those with higher incomes. If exemptions were replaced by tax credits of a fixed amount, all taxpayers would receive the same benefit regardless of their level of income. Indeed, the Carter Commission recommended the replacement of basic exemptions with a tax rate structure that would have had effects similar to that of a credit system, but the plan was never implemented.[11]

Personal deductions reflect the use of the tax system as a device for delivering social policy. Deductions have several objectives, including encouraging savings for retirement or home purchases, education, and charitable donations. Other deductions were established to provide relief from inflation for investors and pensioners. It is far from obvious that these deductions always achieve their stated objectives. In particular, the Registered Home Ownership Savings Plan deduction has been criticized as ineffective and inequitable. Economists Robin Boadway and Harry Kitchen have noted that,

> In almost every way, the current registered home ownership savings plan leaves much to be desired. If one of the objectives of government policy is to increase the incidence of home ownership then surely it can be achieved through a more efficient and effective scheme.[12]

The government has implented two deductions to provide relief from the effects of inflation — the $1,000 deduction for interest and dividend income and the $1,000 pension income deduction. The interest and dividend deduction is an administratively simple way to encourage savings by protecting the income generated from being eroded by inflation. But this protection is limited to savings that generate interest or dividends. Furthermore, it results in larger savings for those in higher tax brackets and is unrelated to the actual rate of inflation.[13] The question for policymakers is whether the incentive to save is worth the revenue loss that accrues disproportionately to upper-income taxpayers.

The pension income deduction, on the other hand, creates little incentive for anything and seems more a direct transfer to the elderly carried

[11]Boadway and Kitchen, p. 49.

[12]Ibid., pp. 63-64.

[13]See Roger S. Smith, *Tax Expenditures: An Examination of Tax Incentives and Tax Preferences in the Canadian Federal Income Tax System*, Canadian Tax Paper no. 61 (Toronto: Canadian Tax Foundation, 1979), p. 70.

out through the tax system. Again, higher-income pensioners with higher marginal tax rates receive the greatest tax savings. This situation could be corrected by eliminating this deduction and transferring the proceeds into OAS payments that would be taxed back on an escalating scale for high-income pensioners.

Thus, while the scope for broadening the personal income tax base may be less than is commonly assumed, this could be achieved to some extent by redesigning several of the personal exemptions and deductions to avoid the negative consequences of higher tax rates discussed earlier. The magnitude of potential revenue increases from personal tax-base broadening is considerable. Personal tax expenditures could easily be worth $20 billion by fiscal 1988. Adoption of the base-broadening measures discussed in this section could raise revenues by as much as $2 billion.

Corporate Income Tax

Corporate tax expenditures also play an important role in narrowing the federal tax base. The objective of the majority of these provisions is to stimulate certain types of industrial investment. Among the tax expenditures listed by the federal government in 1979 were $1.8 billion in accelerated tax depreciation and investment tax credits; encouragement of small business through the reduced tax rate on qualifying small business income; and assistance to firms engaged in research and development activities through fast write-offs of research expenditures and, more recently, through transferable R&D tax credits and deductions.[14] The corporate tax provisions with perhaps the most significant influence on the allocation of resources among industries are those favoring the manufacturing and processing sector of the economy. Manufacturers benefit from the investment tax credit, the two year write-off on manufacturing assets, and a lower corporate tax rate on manufacturing profits. These incentives have been adopted over the years to encourage the development of a competitive manufacturing sector in Canada.

Many studies of the effectiveness of corporate tax expenditures in promoting investment have been conducted, but none has been able to show conclusively that such incentives increase the total level of investment. University of Toronto economist Richard Bird has observed that,

> the answer that emerges clearly from almost all studies that have considered this question carefully is that they affect not the level but the

[14]Department of Finance, *Research and Development Tax Policies* (Ottawa, April 1983), pp. 20-22.

> composition of investment. In other words, incentives to manufacturing investment do, in all probability, increase the amount of investment in manufacturing, but they do so not by raising the total level of investment but in effect by crowding out investment somewhere else.[15]

While corporate tax expenditures may be perceived by some to be an ineffective method of increasing business investment, there are limits to the extent that they can be reduced. This is because similar tax incentives are employed by other countries with which Canada trades and competes for investment. Thus, the reduction of corporate tax expenditures is limited by considerations of international competitiveness.

Federal Sales Tax

The federal sales tax is another candidate for tax-base broadening. Table A-11 shows sales and excise tax expenditures. Services are exempt from the tax, resulting in $5 billion in foregone federal revenues in 1980. Other items are excluded from the tax either because their inclusion would increase the burden of the tax on low-income individuals, as in the case of food, or because the government wishes to encourage certain types of consumption, as in the case of energy conservation goods. Significant exemptions also exist for building materials, equipment, and construction goods.

These exclusions greatly reduce the neutrality of the federal sales tax at the same time as significantly reducing its revenue yield. The exemption of food, clothing, and home heating fuel may be necessary to reduce the regressivity of the tax, but broadening the sales tax base to include services and many currently exempt commodities could generate a significant revenue gain, even with lower tax rates. Extending the federal sales tax to services could create new problems in tax collection and administration. Services would have to be taxed at the retail level, whereas the current federal sales tax is collected from the manufacturer. In the 1970s, there was considerable debate over the suggestion that the federal sales tax be moved to the wholesale or retail level. Most economists favored moving the tax to the retail level but provincial governments that impose their own retail sales taxes opposed such a move.[16] Professor John F. Due of the University of Illinois has suggested that there would be significant mutual advantage to both levels of government if they

[15]Richard M. Bird, *Tax Incentives for Investment: The State of the Art* (Toronto: Canadian Tax Foundation, 1980), pp. 47-48.

[16]See J.M. Dufour and F. Vaillancourt, "Provincial and Federal Sales Taxes: Evidence of Their Effect and Prospect for Change", in Thirsk and Whalley, pp. 429-434.

adopted a uniform retail sales tax base and applied their own tax rates.[17]

New Taxes

An alternative to increasing existing tax rates or broadening existing tax bases would be to implement an entirely new tax. Options for new taxes range from reforms that would replace the existing income tax system with an expenditure tax system, to the addition of one or more new taxes to the existing federal tax structure.

An Expenditure Tax

The erosion of the federal income tax base and resulting concerns about the fairness, efficiency, and yield of the tax system have led some economists to propose that the federal income tax be transformed into an expenditure tax.[18] Under this system, individuals would be taxed on what they consume rather than on what they earn. Taxpayers would compute their taxable expenditures by adding to income any money borrowed and any withdrawals from savings and by subtracting any money saved, including repayment of previous borrowing. Thus, all income that is saved would be exempt from tax, a feature of the tax that would enhance incentives to save and invest. The problem of capital income being taxed at different rates depending on its type and source would be eliminated by an expenditure tax. Capital income, regardless of its form or source, would be free from the tax but would be taxed in the same way as other income when subsequently spent.

Economists Wayne Thirsk and John Whalley have pointed out that Canada has already moved part way toward the taxation of expenditure.[19] The exemption of pension contributions, the tax treatment of housing, and the proliferation of tax-sheltered savings vehicles are all consistent with an expenditure tax. Increases in the limits to private Registered Retirement Savings Plans (RRSPs) contained in the February 1984 budget pushed the system further in this direction. Yet Canada's tax system remains a hybrid of income and expenditure taxation. A move to a full expenditure tax would involve removing the taxation of only one-half of capital gains, the dividend tax credit, and the ex-

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[17]J.F. Due, "Comment," in Thirsk and Whalley, p. 438.

[18]See W.R. Thirsk and J. Whalley, "Introduction: An Overview and Major Themes," in Thirsk and Whalley, pp. 1-18. For a U.S. perspective see M.J. Boskin, "Taxation Savings and the Rate of Interest," *Journal of Political Economy* 86 (April 1978, part 2): S3-S27.

[19]Thirsk and Whalley, "Introduction" in Thirsk and Whalley, p. 13.

emption of the first $1,000 of interest income and of pension income.

Although many economists favor expenditure taxation on the grounds that it would encourage capital formation and perhaps be less complex to administer, some disadvantages and difficulties exist with such a tax scheme.[20]

Some argue that an expenditure tax would be fairer than an income tax because people would be taxed on what they consume of society's output rather than what they contribute to it. Those who oppose the expenditure tax point out, however, that it would be borne more heavily by households — such as the elderly and the unemployed — whose consumption exceeds their income. The transition to a full expenditure tax could also be unfair to people who had saved in taxable forms under the income tax — that is, outside of RRSPs or other tax shelters — who would be taxed again as they consumed their savings unless a grandfather clause was included that allowed a deduction when these savings were consumed.

It is not clear how the adoption of a full expenditure tax would affect federal revenues. The elimination of many existing personal income tax preferences would broaden the tax base, but exempting all forms of savings would have the opposite effect. In addition, revenue from the corporate income tax, which has no theoretical role in an expenditure tax system, would have to be replaced. Many advocates of a full expenditure tax also call for a supplementary tax on wealth as a means of improving the equity of the system and replacing lost revenues.

A move to a full expenditure tax would clearly be a radical departure from the current income tax system. Because of concerns about equity and the transitional difficulties associated with introducing such a system, it is unlikely that the government would adopt this as a means of raising federal revenues. Some analysts do recommend, however, that future moves be made in the direction of an expenditure tax by removing limits to RRSP contributions.[21] Such a move could provide a rationale for eliminating a number of existing personal tax expenditures.

A Value-Added Tax

Another way to tax consumption expenditures and raise revenues would be to impose a federal value-added tax (VAT), similar to that used in many European countries.[22] A VAT is like a sales tax that is based on the

[20]See Douglas Hartle et al, *A Separate Personal Income Tax for Ontario: An Economic Analysis* (Toronto: Ontario Economic Council, 1983), pp. 21-22.

[21]Thirsk and Whalley, "Introduction," in Thirsk and Whalley, p. 13.

[22]See Henry J. Aaron, ed., *The Value-Added Tax: Lessons from Europe* (Washington, D.C.: Brookings Institute, 1981.)

value added at each stage of production. Thus, a VAT in Canada could be a more comprehensive replacement for the existing federal manufacturers' sales tax.

Studies in the United States have assumed that a reasonable tax base for the VAT would be about one-half of total consumption expenditures.[23] In Canada, this would imply that for each percentage point of the tax the revenue yield would be $1.5 billion. Thus, a replacement of the manufacturers' sales tax with a 10 percent value-added tax could raise federal revenue by approximately $5 billion in fiscal 1988.

Although the value-added tax is simple in theory, a number of practical problems have arisen with the implementation of the tax in European countries. Special problems create paperwork and the need for arbitrary decisions on what should be included in the tax base. Transitional problems inevitably arise, particularly when the VAT replaces another tax. U.S. economist Henry J. Aaron argues that,

> while the value-added tax, compared with individualized taxes such as the personal income tax, is simple and cheap to administer, it is not the simple, self-enforcing tax that some of its less sophisticated advocates have suggested.[24]

Those who object to the use of broad-based consumption taxes like the VAT point out that such taxes tend to be borne more heavily by low-income individuals.[25] The regressive nature of the VAT could be reduced, however, by exempting necessities such as food, clothing, and fuel as is currently done with the manufacturers' sales tax. Alternatively, the regressive nature of the VAT could be offset by providing greater low-income relief through the personal income tax. Another disadvantage of the VAT is that it would cause a temporary increase in the inflation rate.

A Minimum Corporate Tax

In 1981, more than 66,000 Canadian corporations — over half the total number — paid no income tax. Yet, these corporations had combined book profits of $12 billion.[26] They paid no taxes on this income because the value of various deductions and tax credits fully offset their tax liability. One method that has been suggested to preclude such a situation would be to impose a minimum corporate tax levied on a more com-

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[23]Galper, p. 198.

[24]Aaron, p. 9.

[25]Hartle et al., p. 7; and U.S. Congressional Budget Office, p. 196.

[26]Statistics Canada, *Corporate Taxation Statistics 1980*, Cat. no. 61-208 (Ottawa, August 1983), p. 132.

prehensive definition of corporate income than is used in the present tax system.[27] For example, a tax could be imposed on net income as is currently done in the PGRT, which allows no deductions for depreciation, depletion, interest expenses, research and development expenses, or any of the other usual items allowed under the corporate income tax. A similar tax on a comprehensive measure of corporate income could generate significant new federal revenues. Assuming that the tax base was approximately equal to 90 percent of corporate net income, then each percentage point of the tax would yield about $500 million in fiscal 1988.

A minimum corporate tax on net income would have the advantage of being widely spread across all corporations. It would also avoid one of the main disadvantages associated with simply applying a surtax on the existing corporate tax base, namely that of many companies being able to avoid the tax because they qualify for tax expenditures that fully offset their taxable income. A surtax would encourage greater artificial use of special corporate tax provisions to avoid paying tax and thereby worsen existing distortions in the allocation of resources. The objection to a tax on net income is that it disallows deduction of many justifiable business expenses. By disallowing the deduction of depreciation expenses and interest costs, for example, such a tax discourages investment. Smaller firms that are growing rapidly would tend to bear a larger burden from a comprehensive minimum tax than would mature, slow-growing firms. Manufacturing firms would also bear a larger burden since they derive the greatest benefit from existing corporate tax provisions.

Summary

Raising tax revenues to reduce the federal deficit could be accomplished in a variety of ways. Judging among the alternatives will require policymakers to weigh the economic consequences of each. Some options are clearly superior to others in terms of spreading the burden of tax increases and removing existing distortions in the tax system. Tax rate increases, for example, could have a negative impact on incentives and push more activity into the underground economy. Measures to broaden existing tax bases, on the other hand, could simplify the tax system, increase its perceived fairness, and encourage greater voluntary compliance among taxpayers. Selective attempts to reduce tax expenditures, however, have met with considerable political resistance in Canada.

[27]U.S. Congressional Budget Office, p. 242.

Once implemented they become difficult to remove. In the case of corporate tax expenditures, policymakers must also avoid reducing the international competitiveness of Canadian firms relative to firms in other countries that offer similar tax expenditures.

If neither increasing tax rates nor broadening tax bases proves to be an economically or politically acceptable option for raising revenues, a new, broad-based tax could be incorporated into the existing tax structure as a means of reducing the deficit. Greater public debate of alternative methods of raising federal revenues would serve the useful function of improving Canadians' understanding of the existing tax system, as well as clearly defining the choice between expenditure cuts and tax increases.

4

Choosing a Strategy

A continuation of the fiscal status quo, which would produce huge federal deficits for the foreseeable future, poses serious risks. Yet, there appears to be only a vague perception of the significance of persistent deficits and, consequently, a lack of debate about options for deficit reduction.

Eventual action to reduce deficits is inevitable. The continuing increase of federal debt relative to GNP is an inherently unstable situation. Rising interest rates associated with heavy debt financing could touch off another recession in the mid-1980s. In that event, deficits and the debt could spiral, forcing severe fiscal austerity. Alternatively, monetization of deficits to keep interest rates from rising could reignite inflationary expectations and force another severe, policy-induced recession.

If action is taken soon, however, drastic measures could be avoided and deficits could be reduced at a controlled pace that would enhance prospects for long-term economic growth and stability. Delay contributes to growth both of the debt and of interest charges and makes solutions more difficult to achieve.

The preceding chapters of this *Observation* have evaluated individual options for reducing planned federal spending and accelerating the growth of revenues. Formulating a deficit reduction strategy involves making choices among these options. Choosing a strategy will require Canadians to reach a workable consensus about the role of government in society and the ability of government to resolve economic and social problems. In the area of economic development policy, for example, Canadians will have to decide whether government should continue to shield private industry from changes in the world economic environment or whether it should provide only temporary adjustment assistance to firms and individuals that are hurt most by change. It will also mean reassessing methods of delivering essential social programs to ensure they meet their basic objectives at a reasonable cost.

What is ultimately at issue is how to bring the deficit down in a way that preserves the fundamental role that Canadians perceive their federal government should play. Resolving this issue will require Canadians to choose the extent to which they are willing to see government services reduced and the extent to which they are willing to pay higher taxes to finance existing programs.

What Do Canadians Want?

Although Canadians do not view either the government deficit or the public debt as a leading economic problem, that does not mean they are indifferent. On the contrary, public opinion polls have consistently demonstrated support for restraint in the public sector. Three out of four Canadians approved of the federal government's "6 and 5" program, which limited wage increases for public servants.[1] Two out of three also believe that reducing government deficits would improve economic performance.

While there is a clear preference for fiscal restraint, it is less clear how Canadians feel this should be achieved. Only one in five favor raising taxes to reduce the deficit. Two out of three believe that deficits should be cut by reducing government services. As pollster Martin Goldfarb has observed,

> The reality is the public generally believes that government could do more with less money. People are saying that they think taxes are high, but they are also saying that they are not overburdened by taxes. They do not want taxes to go up, but they do not expect them to go down. They want government to cut programmes, but they do not want less service. It is folly to think that people are moving in the direction of less government.[2]

When asked in what specific areas they would favor spending cuts to reduce government deficits, Canadians responded as shown in Figure 6. Options favored by a majority of Canadians included reducing staff levels in the public service, reducing postal service, cutting assistance to

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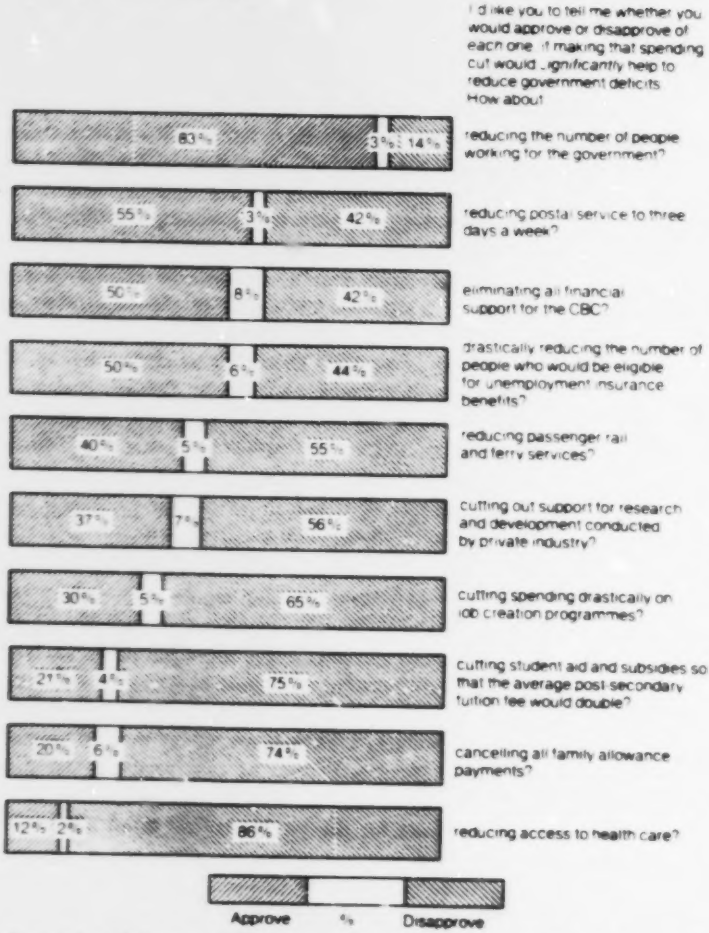
[1]Public opinion data presented in this section are drawn from a survey conducted by Decima Research Limited in September 1982. Results are reported in Ian McKinnon, "What Does the Public Think about Deficits? What Does Bay Street Think about Deficits?" in David W. Conklin and Thomas J. Courchene, eds., *Deficits: How Big and How Bad?* (Toronto: Ontario Economic Council, 1983), pp. 189-214.

[2]Martin Goldfarb, "The Public's View of Government Restraint," in Peter Aucoin, ed., *The Politics and Management of Restraint in Government* (Montreal: Institute for Research on Public Policy, 1981), p. 71.

FIGURE 6

Levels of approval for spending cuts in specific areas in order to reduce government deficits



Source: Ian McKinnon, "What Does the Public Think about Deficits? What Does Bay Street Think about Deficits?" in D.W. Conklin and T.J. Courchene, eds., *Deficits: How Big and How Bad?* (Toronto: Ontario Economic Council, 1983), p. 199. Reproduced with permission from the Ontario Economic Council.

the CBC, and limiting eligibility for unemployment insurance. Options that were rejected by a majority included cuts in rail and ferry service, cuts in support for R&D and student aid, cuts in direct job creation programs and, most emphatically, cuts in social programs such as family allowance payments and health care.

These results perhaps explain why deficits have been allowed to persist for so long in Canada. Canadians have a schizophrenic attitude toward the deficit. While there is a definite preference for deficit reduction, the measures the public favors are inadequate to get the job done. People do not want taxes to go up. They do not want social welfare, health, or education spending cut. They would prefer to have the government cut spending by reducing the public service, limiting payments to privileged crown corporations and agencies, and tightening up eligibility for unemployment insurance. It is difficult, however, to envisage a major reduction in the federal deficit if action was limited to these options.

It will require political will to develop a strategy to tackle the deficit and leadership to introduce budgetary changes to get the job done. To command public support, the strategy should be based on principles that aim to:

- *Spread the burden.* An early decision is needed to determine how much of the target deficit reduction is to be achieved by spending restraint and how much by tax increases. While it would be possible to cut the deficit entirely on one side of the budget, program cutbacks or tax hikes of the necessary magnitude would be disruptive and would concentrate the burden either on beneficiaries of government programs or on taxpayers. If the problem is that Canadians are consuming more public goods than they have been paying for, then the solution should be found in a broadly based strategy. Some contribution should come on the spending side and some on the tax side of the budget. This does not imply that all government services should be cut proportionally or that revenue increases should be spread evenly over all tax bases. The previous chapters have indicated that a case can be made for the burden to fall more heavily on some sectors than others.
- *Rely more on the private sector.* The thrust of much government spending and tax expenditures is to protect or subsidize particular groups, industries, or regions of the country. These policies replace market incentives and, consequently, slow down or totally eliminate adjustment to changing domestic and international market conditions. Cutting the deficit by reducing these types of spending and tax preferences would increase the flexibility and dynamism of the Canadian economy.

• *Provide services citizens cannot provide for themselves.* The federal government provides many services, such as defense, the justice system, social insurance, and economic infrastructure that would not be provided by the private sector. Deep cuts in these types of programs should be avoided.

• *Promote lower interest rates.* Lower interest rates would offset the effects of fiscal restraint on economic growth. The deficit should, therefore, be reduced in ways that promote lower interest rates. Spending cuts, by permanently reducing the government's claim on real resources, would likely have a more favorable impact in terms of lowering interest rates than would tax increases. Raising indirect taxes, by temporarily increasing inflation, could have the counterproductive result of raising nominal interest rates. Reducing tax incentives that encourage domestic saving could also push up interest rates.

• *Reduce flaws in the tax system.* Many Canadians believe that the present tax system is unfair and too complex. If the deficit is to be reduced by raising taxes, then it is important that the increased tax burden be distributed in a way that is fair and that reduces distortions caused by existing tax rules. This means that provisions of the current tax system that favor specific groups or activities must be carefully examined and removed if found to be no longer justified. Tax rate increases should be confined to those taxes, such as the personal income tax, that have a relatively comprehensive base. Broadening existing tax bases, in addition to raising revenue, would simplify the tax system and reduce special privileges.

• *Avoid measures that weaken the social safety net.* The slow recovery from the 1981-82 recession has increased the need for both unemployment insurance and social assistance. The changing structure of industry and jobs increases the need for government programs to assist people in relocating and retraining. Deficit reduction measures should aim to redesign safety net programs in ways that promote economic adjustment while maintaining the indispensable insurance function that such programs provide.

Alternative Strategies: Some Illustrations

These general principles are consistent with many different deficit reduction strategies. The choice among alternative strategies must, in the end, be based upon a set of collective value judgments by Canadians about federal public services and taxes. Three alternatives serve to illustrate how different values can affect the choice of deficit reduction strategies. The first alternative reflects the judgment of those who believe that the

existing size and role of government spending programs is about right. This group would oppose cuts in government services and favor increased government efficiency and increased revenues as the appropriate method of cutting the deficit.

The second alternative reflects the judgment that, while the level of federal services is about right, substantial savings could be achieved by more careful targeting of the $50 billion spent each year on social programs. This group would support the redesign of social transfer programs to begin the task of deficit reduction and some tax increases to get the job done.

The third alternative is based on the view that taxes are already too high and that government programs are often ineffective, or even counterproductive, in achieving their objectives. The best approach to deficit reduction, according to this view, would be to cut back government spending selectively, based on a tough evaluation of each program's effectiveness. If sufficient spending cuts cannot be found to achieve the deficit reduction target, then some tax increases — perhaps designed to reduce distortions in the tax system — should be implemented.

Each of these alternatives, examined in more detail below, observes the basic principles set out earlier, yet apportions the burden of deficit reduction quite differently. The purpose in presenting these strategies is to illustrate some of the choices Canadians face in designing a package to cut the deficit.

Preserve Government Services, Raise Revenue

This strategy, shown in Table 7, would cut the deficit while maintaining government services through a combination of improving government efficiency and raising revenue growth. Improving efficiency — having government provide the same level of service for less money — could be achieved by rationalization and consolidation of government programs and departments, increased reliance on user fees for public services, reduced commitments to crown corporations, and continued pay restraint in the public service. It is possible that such a program could yield expenditure savings of $2 billion per year by fiscal 1988. Achieving a target of reducing the federal deficit to 1 percent of GNP would then require that an additional $7 billion of federal revenue be generated. Slower growth of the public debt could save another $2 billion in debt interest charges.

One method of spreading the burden of higher taxes would be to rely

primarily upon a broadly based consumption tax. The value-added tax discussed in Chapter 3 could replace the current federal sales tax and, if set at a rate of 10 percent, could generate a net increase of $5 billion in federal revenue. Reductions in personal and corporate tax expenditures could yield an additional $2 billion in federal revenue.

TABLE 7

Deficit Reduction Strategy 1: Preserve Government Services, Raise Revenue

Spending changes ($ millions)		Revenue changes ($ millions)	
Improve efficiency in government	-2,000	Reduce personal income tax expenditures	1,000
Reduce debt interest	-2,000	Reduce corporate income tax expenditures	1,000
		Replace federal sales tax with 10 percent VAT	5,000
Total	*-4,000*		*7,000*

Source: C.D. Howe Institute.

This strategy would have the advantage of spreading the burden of deficit reduction broadly across the population while preserving the level of federal services. The beneficiaries of major government expenditure programs would be unaffected, thereby limiting political resistance to such a strategy.

There are several important offsetting aspects to this approach, however. First, it would raise the overall level of taxation to maintain planned spending. Second, it would forego an important opportunity to improve the design of existing expenditure programs. Third, it would do little to slow the steady rise in federal spending relative to national income. Canadians would preserve the level of government services they have come to expect, but they would do so by accepting a permanently increased role of government in society.

Target Social Spending, Raise Revenue

There are some Canadians who believe that spending on social programs has increased beyond the capacity of the economy to finance them. Others feel that social spending programs could be redesigned to provide greater assistance to low-income groups at a much lower cost to the federal purse. Similarly, many existing personal tax exemptions aimed at providing benefits to the aged, to families, and to first-time homebuyers provide the greatest benefit to high-income individuals.

There is considerable scope for reducing the federal deficit by improved targeting of social spending and personal tax provisions simply because of the magnitude of these programs. Thus, improved targeting of the $6 billion family income security tax and transfer programs could result in a $1 billion reduction in the deficit without having any impact on the net benefits received by families with incomes below the median level. The reason for this is that many of the benefits of existing social programs flow to middle- and upper-income individuals and families. The Economic Council of Canada has observed that,

> Most social programs are categorical, in the sense that they are intended to benefit a particular group — the aged, the young, the sick, the unemployed, and mothers with children — rather than a particular income level. But as programs expand and become more universally accessible, inevitably they embrace more and more middle- and upper-income families.[3]

Either middle-income earners pay higher taxes or the federal government borrows more in order to finance social transfers that largely benefit middle-income groups. In spite of the limited efficiency of existing social programs in redistributing income to low-income groups, recipients have built up a very strong sense of entitlement regardless of the level of their family income.

TABLE 8

Deficit Reduction Strategy 2: Target Social Spending, Raise Revenue

Spending changes ($ millions)		Revenue changes ($ millions)	
Increase tax-back of OAS to upper-income recipients	-500	Reduce personal and corporate tax expenditures	1,000
Increase tax-back of Family Allowance to upper-income families	-1,000	Replace federal sales tax with 10 percent VAT	5,000
Introduce UI experience rating, reduce federal contributions	-1,200		
Reduce debt service costs	-2,000		
Total	*-4,700*		*6,000*

Source: C.D. Howe Institute.

Improved targeting of social programs requires a careful review of the objectives of each program, of how the net benefits vary across

[3]Economic Council of Canada, *A Time For Reason: Fifteenth Annual Review* (Ottawa: Supply and Services Canada, 1978), p. 116.

households at different levels of income, and of whether the program is more effectively delivered through the tax system or through transfer payments. For example, do we want to reduce net benefits more quickly as family incomes rise? Do we want to phase out net benefits entirely above a certain income level?

It is important to recognize that improved targeting of social transfers does not require that we abandon universal programs. Reducing transfers to higher-income recipients by introducing greater selectivity or income-testing is virtually equivalent to raising their taxes. The net benefits of universal programs can be reduced for upper-income recipients by applying a special higher tax-back rate on such payments. For this reason, continuation of universal programs may be fully justified and consistent with improved targeting of social benefits.

A strategy that would reduce the federal deficit by $11 billion in fiscal 1988 by targeting social transfers and raising revenues is shown in Table 8. This strategy would achieve expenditures savings of $2.7 billion by increasing the tax-back of pension and family allowance benefits to upper-income recipients and by introducing experience rating of unemployment insurance premiums. Net benefits to low-income families could be maintained at planned levels while those to upper-income individuals would be reduced. Revenues could be increased by the implementation of a 10 percent value-added tax and reductions in personal and corporate tax expenditures.

Cut Spending, Preserve Social Programs

Many Canadians balk at suggestions that deficit reduction should be achieved by changes in Canada's well-developed and universally accessible system of social programs. Both social insurance programs such as unemployment insurance and universal income security programs such as the old age pension reflect the importance Canadians attribute to equality of access and opportunity. These policies allow national standards to be set and adhered to across provinces and are an important part of Canadians' concept of Confederation.

The Economic Council of Canada has pointed out that "for some Canadians, any breach of the principle of universality, especially in contributory schemes, would be ideologically unacceptable."[4] If the majority of Canadians believe that existing universal programs are an indispen-

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[4]Ibid., p. 101.

sable feature of Canadian society, then other ways of reducing the deficit must be sought.

An alternative is to restrain the growth of most other government expenditure programs and to raise taxes to achieve the deficit reduction target. This strategy, illustrated in Table 9, would involve reductions in planned expenditures on economic and regional development, defense and foreign aid, unemployment insurance, direct social spending, and federal compensation and operating expenses.

TABLE 9

Deficit Reduction Strategy 3: Cut Spending, Preserve Social Programs

Spending changes ($ millions)		Revenue changes ($ millions)	
Reduce economic and regional development spending	-2,700	Impose one percent surtax on personal income tax liabilities	450
Limit defense and foreign aid	-500	Impose one percent surtax on corporate income tax liabilities	125
Reduce commitments to crown corporations	-400	Increase federal sales tax by one percent	1,100
Reduce federal contributions to UI	-1,200		
Limit direct social spending	-500		
Restrain compensation and operating costs	-2,000		
Reduce debt service costs	-2,000		
Total	*-9,300*		*1,675*

Source: C.D. Howe Institute.

Federal transfers to business would be reduced substantially if this strategy was adopted. While the rationale for government assistance to business has achieved a degree of consensus in Canada, the proliferation of programs calls into question their effectiveness. For example, Gordon Ritchie, Associate Deputy Minister of the Department of Regional Industrial Expansion, has noted that it would be hard to identify a firm in an industry that could not somehow justify direct government aid.[5] The net effect of subsidization of such a broad range of industrial activities is largely unknown. The sums involved are in the billions of dollars. Yet the original rationale has in many cases become blurred. Aid programs are infrequently reviewed to determine whether existing levels of support continue to be merited.

Even though many government economic and regional development

[5]Gordon Ritchie, "Government Aid to Industry," *Canadian Public Administration* 26 (Spring 1983): 36-46.

programs have worthwhile objectives, it might be in the long-term interest of the corporate sector to support a phased reduction in direct assistance to industry in order to reduce prospective federal deficits. The corporate sector is among the most outspoken of critics of government deficits. It also stands to benefit from reduced federal borrowing requirements and reduced federal intervention in the economy that could follow from a reduction in economic and regional development spending.

How would the Canadian economy be changed by this strategy? Universal access of social transfer programs would be preserved, as would currently planned levels of benefits. Indeed, social spending would increase in relative importance in total federal spending. Both the size of government and its intervention in private economic activity, however, would be considerably reduced. Transfers to the petroleum industry, to agriculture, to energy users, and to firms participating in industrial and regional development programs would be curtailed.

Investment would be attracted into those activities offering the best market rate of return rather than the best government incentives. Some reallocation of labor from subsidized sectors into other activities would also take place. Government training and mobility assistance would be required to facilitate adjustment and reallocation to expanding industries.

Households would be called upon to increase their contribution to covering the cost of public services, both through modest tax increases and through higher user fees for government services, particularly in the transportation sector. For the majority of Canadians, however, these costs would be more than offset by lower interest rates and more secure employment prospects associated with increased private investment.

Can It Be Done?

Each of these three strategies would have a widely dispersed beneficial effect on the Canadian economy. Growth of the federal debt would be brought down; the Bank of Canada would be allowed more room to maneuver in holding interest rates down; government spending would be made more effective and less protective of special interests; and the tax system would be fairer and simpler. Every Canadian would benefit from such changes.

Selected industries or groups of individuals that benefit directly from existing government programs or tax preferences would be hurt, however. These special interests would undoubtedly mount well-

organized opposition to specific deficit reduction options that directly affect them. Can any government overcome such opposition, which threatens to entrench the status quo of persistent large federal deficits?

The answer is a qualified yes. The federal government could deal effectively with the deficit if three conditions are met. First, there must be a full and open public debate of options for achieving deficit reduction and their consequences. Second, the government must present a credible strategy for reducing the deficit and be prepared to offset the contractionary impact of fiscal restraint with lower interest rates. Third, it must gain the support and cooperation of groups that favor lower deficits and, where necessary, ease the transition for groups that are hurt.

A broad public discussion of deficit reduction options is an essential prerequisite to policy action. Without this discussion there is a risk that expenditure cuts and tax increases could be concentrated on segments of society with the weakest political voice. The federal deficit in Canada must be reduced, but it need not be done at the expense of such groups. But if action is delayed and rising interest rates or recession force fiscal austerity upon us without time for adequate public debate, deficit reduction could have highly disruptive consequences.

The short-term contractionary effect of deficit reduction on economic growth and employment can be offset if the Bank of Canada relaxes monetary policy and allows interest rates to decline. The future course of Canadian interest rates will continue to be heavily influenced by U.S. economic policy, but a credible strategy to reduce the federal deficit would increase the Bank's ability to maintain lower interest rates. Indeed, a commitment to offsetting monetary policy is an essential part of an acceptable deficit reduction strategy.

Finally, to be successful the government must have effective cooperation from groups opposed to large deficits. The business and financial communities in Canada have been outspoken opponents of large deficits. Endorsement by Canadian business of actions to reduce federal aid to industry and some corporate tax expenditures would contribute to deficit reduction and make easier the task of limiting other forms of spending or raising other taxes. But this would not be enough. Spending and tax changes that bear heavily on particular groups would have to be phased in gradually: in some cases, grandfather provisions may be necessary; in others, temporary assistance to help individuals or firms adjust to the new environment may be required.

Most important of all, the government must build a credible strategy for tackling the deficit and stick to it. Such a strategy can only be

developed if Canadians openly and actively debate the choices facing them. If the debate does not begin soon, we run a serious risk. If we do not act soon to control the deficit, it could end up controlling us.

Appendix

TABLE A-1

Alternative Paths for the Federal Deficit and the Federal Debt, fiscal years 1978-88

	Financial requirements		National Accounts deficit		Net federal debt*	
	$ millions	% of GNP	$ millions	% of GNP	$millions	% of GNP
1978	8,449	4.9	9,388	4.5	22,300	21.4
1979	11,113	4.8	9,597	4.1	34,900	15.0
1980	10,449	4.0	9,083	3.4	44,600	16.9
1981	10,117	3.4	8,994	3.0	55,800	18.8
1982	8,331	2.5	9,374	2.8	64,200	18.9
1983	23,256	6.5	22,840	6.4	87,900	24.6
1984	27,000	6.9	25,500	6.5	112,800	29.0
Department of Finance Fiscal Plan						
1985	25,550	5.9	25,000	5.8	141,000	32.6
1986	23,300	5.0	21,200	4.5	163,100	34.7
1987	19,700	3.8	17,800	3.5	181,800	35.5
1988	18,650	3.4	18,200	3.3	200,600	36.1
Deficit path to stabilize debt-to-GNP ratio						
1985	25,500	5.9	25,500	5.8	140,100	32.6
1986	20,300	4.3	18,200	3.9	160,400	34.2
1987	12,700	2.7	10,700	2.1	173,100	33.7
1988	7,700	1.4	7,000	1.3	180,800	32.6

*Net fixed-value liabilities of the federal government

Note: data for 1984 are estimated; data for 1985-88 are projected

Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1984), and C. D. Howe Institute

TABLE A-2

Federal Expenditures by Major Policy Area, fiscal years 1981-88[a]

Policy area	1981	1982	1983	1984	1985	1986	1987	1988
	$ billions							
Economic and regional development[b]	8.8	8.5	11.6	14.1	15.3	15.3	15.2	15.6
Social development[c]	25.8	29.0	35.5	39.8	41.7	43.5	46.3	49.0
Defense and foreign affairs[d]	6.5	7.7	9.0	10.3	11.5	12.5	13.6	14.9
Public debt interest	10.5	14.3	16.8	17.9	20.1	22.1	23.4	24.4
Other[e]	11.6	16.3	18.6	16.2	18.8	21.1	22.7	24.5
Total[f]	*62.9*	*75.8*	*89.6*	*98.4*	*107.5*	*114.5*	*121.2*	*128.5*
	As a percentage of total expenditure							
Economic and regional development	14.0	11.2	12.8	14.4	14.2	13.4	12.5	12.2
Social development	41.1	38.2	37.4	40.6	38.8	38.0	38.2	38.2
Defense and foreign affairs	10.3	10.2	10.1	10.5	10.7	10.9	11.3	11.6
Public debt interest	16.7	18.8	18.8	18.2	18.7	19.3	19.3	19.0
Other	18.5	21.5	20.8	16.4	17.5	18.4	18.8	19.1
Total[f]	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*
	As a percentage of GNP							
Economic and regional development	3.0	2.5	3.2	3.6	3.6	3.3	3.0	2.8
Social development	8.7	8.5	9.4	10.2	9.7	9.3	9.0	8.8
Defense and foreign affairs	2.2	2.3	2.5	2.6	2.7	2.7	2.7	2.7
Public debt interest	3.5	4.2	4.7	4.6	4.7	4.7	4.6	4.4
Other	3.9	4.8	5.2	4.1	4.4	4.5	4.4	4.4
Total	*21.2*	*22.3*	*25.1*	*25.3*	*25.0*	*24.4*	*23.6*	*23.1*

[a]Data for 1984 are estimated; data for 1985-88 are projected.
[b]Includes spending allocated to the Economic Development and Energy envelopes.
[c]Includes spending allocated to the Social Affairs and Justice and Legal envelopes.
[d]Includes spending allocated to the Defence and External Affairs and Aid envelopes.
[e]Includes spending allocated to the Services to Government, Parliament, and Fiscal Arrangements envelopes, and adjustments to national accounts basis. The largest component of the adjustments is payments for UI and pensions for federal employees.
[f]Totals may not add, due to rounding.

Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1984).

TABLE A-3

Economic and Regional Development Spending, fiscal year 1985[a]
($ millions)

Government department	Employee compensation	Operating expenses	Capital spending	Transfer payments	*Total*
Agriculture	437.9	128.7	85.2	1,140.4	*1,792.2*
Communications	80.2	53.2	24.4	18.2	*176.0*
Consumer and Corporate Affairs	94.0	38.7	5.0	116.3	*254.0*
Economic and Regional Development	15.8	7.4	—	0.3	*23.5*
Energy, Mines and Resources[b]	409.0	356.0	62.3	3,219.8	*4,047.1*
Environment: Forestry	44.5	22.3	31.1	47.2	*145.1*
External Affairs: Export promotion	19.0	9.5	—	487.9	*516.4*
Fisheries and Oceans	240.7	218.3	210.3	20.8	*690.1*
Labour	36.6	8.1	0.3	55.8	*100.8*
Regional Industrial Expansion	126.4	108.2	1.2	1,234.3	*1,470.1*
Science and Technology	158.9	119.6	127.5	389.8	*795.8*
Supply and Services	—	—	—	25.0	*25.0*
Transport	820.4	422.1	826.4	1,720.0	*3,788.9*
Total	*2,483.4*	*1,492.1*	*1,373.7*	*8,475.8*	*13,825.0*
Percent of total	*18.0*	*10.8*	*9.9*	*61.3*	*100.0*

[a]Includes the Economic Development and Energy envelopes.
[b]Includes $331.4 million for Atomic Energy of Canada Limited and $520.7 million for Petro-Canada and Petro-Canada International Assistance Corporation.

Source: Government of Canada, *1984-85 Estimates* (Ottawa: Supply and Services Canada, 1984).

TABLE A-4

Major Grants and Transfers for Economic and Regional Development, fiscal year 1985 ($ millions)

Transfer program	Major beneficiaries[a]	Projected 1985 spending
Agricultural Stabilization Act	Farmers	402.2
Crop Insurance Act	Farmers	150.0
Farm Credit Corporation	Farmers	494.2
Western Grain Stabilization Act	Farmers	150.0
Assistance to homeowners with UFFI[b]	Homeowners	101.5
Natural gas distribution	Gas distribution companies	337.0
Petroleum Compensation payments	Petroleum consumers	290.8
Oil Substitution-Conversion Assistance	Homeowners	125.9
Canadian Home Insulation Program	Homeowners	188.5
Petroleum Incentive Payments	Petroleum industry	1,600.0
Other energy grants and transfers	Energy industry	677.6
Export Development Corporation	Export industries	287.0
Regional and industrial development	Corporations	1,076.0
Cape Breton Development Corp.	Crown corporation	134.4
National Research Council grants	Scientific community	116.5
Natural Sciences and Engineering Research Council grants, scholarships	Scientific community	271.5
Payments to VIA Rail	Rail passengers	679.4
Other railway payments	Railways and shippers	310.9
Payments to CN Marine: Ferry Service	Ferry passengers	164.7
Canadian Transport Commission payments	Railways, trucking companies	475.9
Other transfers		441.8
Total		*8,475.8*

[a]These beneficiaries are the recipients of the transfers. Secondary beneficiaries include individuals and firms that supply goods and services to the recipients. Examples include farm equipment suppliers, energy conservation contractors, and oil and gas drilling equipment suppliers.

[b]Urea formaldehyde foam insulation.

Source: Government of Canada, *1984-85 Estimates* (Ottawa: Supply and Services Canada, 1984).

TABLE A-5

Social Development Expenditures, fiscal years 1983-88

	1983	1984	1985	1986	1987	1988
	$ millions					
Transfers to persons						
Unemployment insurance[a]	2,148	2,854	2,709	2,495	2,297	2,168
Pensions[b]	9,643	10,442	11,584	12,714	13,677	14,620
Family Allowance	2,231	2,327	2,429	2,561	2,723	2,870
Sub-total	*14,022*	*15,623*	*16,722*	*17,770*	*18,697*	*19,658*
Transfers to provinces						
Health and education[c]	5,592	7,746	7,535	8,112	8,999	9,832
Canada Assistance Plan	2,832	3,431	3,696	3,975	4,252	4,303
Sub-total	*8,424*	*11,177*	*11,231*	*12,087*	*13,251*	*14,135*
Direct social spending	11,083	13,096	13,791	13,660	14,320	15,236
Total	*33,529*	*39,896*	*41,744*	*43,517*	*46,268*	*49,029*
	As a percentage of total outlays					
Transfers to persons						
Unemployment Insurance	2.7	3.1	2.8	2.4	2.1	1.9
Pensions	12.1	11.5	11.8	12.3	12.6	12.7
Family Allowance	2.8	2.6	2.5	2.5	2.5	2.5
Sub-total	*17.6*	*17.2*	*17.0*	*17.2*	*17.2*	*17.0*
Transfers to provinces						
Health and education	7.0	8.5	7.7	7.9	8.3	8.5
Canada Assistance Plan	3.5	3.8	3.8	3.8	3.9	3.7
Sub-total	*10.5*	*12.3*	*11.5*	*11.7*	*12.2*	*12.2*
Direct social spending	13.9	14.4	14.2	13.2	13.1	13.2
Total	*42.0*	*43.9*	*42.7*	*42.1*	*42.5*	*42.4*

[a]Federal contribution to unemployment insurance. Total UI expenditures, which are largely financed by employer and employee contributions, are projected to be $11.6 billion in fiscal year 1985.

[b]Old age security, guaranteed income supplement and spouse's allowance.

[c]Established programs financing.

Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1984), p. 25.

TABLE A-6

Direct Social Spending, fiscal year 1985[a]
($ millions)

Government department	Employee compensation	Operating expenses	Capital spending	Transfer payments	*Total*
Communications	242.3	83.9	23.1	905.7	*1,255.0*
Employment and Immigration	793.8	111.0	6.0	1,113.6	*2,024.4*
Environment	436.3	73.7	144.4	87.4	*741.8*
Indian and Northern Affairs	234.1	372.8	111.0	1,400.3	*2,118.2*
Justice	154.7	48.4	1.0	71.8	*275.9*
Health and Welfare	333.4	9.5	32.1	350.1	*725.1*
Canada Mortgage & Housing Corp.	—	—	—	—	*1,417.8*
Solicitor General	1,345.0	55.8	233.6	33.0	*1,667.4*
Secretary of State	119.6	49.2	2.2	625.9	*796.9*
Veterans Affairs	128.7	168.2	2.8	1,221.9	*1,521.6*
Total	*3,787.9*	*972.5*	*556.2*	*5,809.7*	*12,544.1*

[a]Excludes major statutory transfer programs.

Source: Government of Canada, *1984-85 Estimates* (Ottawa: Supply and Services Canada, 1984)

TABLE A-7

Major Grants and Transfers in Direct Social Spending, fiscal year 1985 ($ millions)

Transfer program	Major beneficiaries	Projected 1985 spending
Grant to CBC	Crown corporation	895.7
Direct job creation	Unemployed	718.0
Training grants	Training institutes	368.6
Employment services	Employers, unemployed	39.9
Indian Affairs grants	Native groups	856.6
Northern Development grants	Territorial governments	533.7
Fitness and Amateur Sport grants	Sports organizations	52.9
Medical research grants	Medical researchers, students	153.2
Social housing grants	Coops, low-income families	1,017.3
Other housing grants	Native people	327.8
Official languages grants	Other levels of government	227.6
Canada student loans	Students	229 0
Citizenship development grants	Ethnic and women's groups	99.0
Veterans support	Veterans	505.5
Veterans pensions	Veterans	716.4

Source: Government of Canada, *1984-85 Estimates* (Ottawa: Supply and Services Canada, 1984).

TABLE A-8

Sources of Federal Revenue, fiscal years 1981-88[a]

Policy area	1981	1982	1983	1984	1985	1986	1987	1988
				$ billions				
Personal income tax	19.8	24.0	26.3	28.3	32.8	37.0	40.8	45.2
Corporate income tax	8.1	8.1	7.1	7.8	9.8	10.3	11.4	12.5
Energy taxes	1.5	3.3	4.0	3.7	3.9	4.0	4.4	4.7
Social insurance premiums	6.6	6.4	6.6	9.1	10.2	11.6	13.3	12.0
Federal sales tax	5.4	6.2	5.9	6.6	7.3	8.8	9.5	10.4
Investment income	4.9	5.6	6.6	6.8	7.0	7.7	8.2	8.9
Other[b]	6.5	11.6	10.1	10.7	11.3	13.9	13.7	16.7
Total[c]	*52.8*	*65.2*	*66.7*	*72.9*	*82.5*	*93.3*	*103.4*	*110.3*
				As a percentage of total revenue				
Personal income tax	37.5	36.8	39.4	38.8	39.8	39.6	39.4	41.0
Corporate income tax	15.3	12.4	10.6	10.7	11.9	11.0	11.0	11.3
Energy taxes	2.8	5.1	6.0	5.1	4.7	4.2	4.3	3.9
Social insurance premiums	12.5	9.8	9.9	12.5	12.3	12.4	12.0	10.9
Federal sales tax	10.2	9.8	8.8	9.1	8.8	9.4	9.1	9.4
Investment income	9.2	9.5	9.9	9.3	8.4	8.2	7.9	8.1
Other	12.3	17.8	15.1	14.7	13.6	14.8	14.3	15.1
Total[d]	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*
				As a percentage of GNP				
Personal income tax	6.7	7.1	7.4	7.3	7.6	7.9	8.0	8.1
Corporate income tax	2.7	2.4	2.0	2.0	2.3	2.2	2.2	2.3
Energy taxes	0.5	1.0	1.1	0.9	0.9	0.9	0.9	0.8
Social insurance premiums	2.2	1.9	1.9	2.3	2.4	2.5	2.6	2.2
Federal sales tax	1.8	1.8	1.7	1.7	1.7	1.9	1.9	1.9
Investment income	1.7	1.7	1.9	1.7	1.6	1.6	1.6	1.6
Other	2.2	3.4	2.8	2.7	2.6	3.0	3.1	3.0
Total	*17.8*	*19.2*	*18.7*	*18.7*	*19.2*	*19.9*	*20.2*	*19.8*

[a]Data for 1984 are estimated; data for 1985-88 are projected.
[b]Includes adjustments to National Accounts basis.
[c]National Accounts basis.
[d]Totals may not equal 100, due to rounding.

Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1984), pp. 9-11, 40.

TABLE A-9

Personal Tax Expenditures, 1980
($ millions)

Income exclusion tax expenditures	
One-half rather than full taxation of capital gains	500
Dividend gross-up and tax credit	800
Exemption of first $500 of research grants	5
Exemption of capital gains on principal residences	3,500
Exemption of imputed rent on owner-occupied homes	5,000
Total	*9,805*
Deduction tax expenditures	
Contributions to Canada and Quebec Pension Plans	540
Unemployment Insurance Contributions	615
Deductions for RRSPs and RPPs	2,600
Deductions for RHOSPs	95
Deductions of tuition fees	34
Exemption of first $1,000 of investment income	665
Deduction for gifts to the Crown	n.a.
Exemption of first $1,000 of pension income	105
Deduction for charitable donations	375
Special $50 per month education deduction	30
Ability to shelter income through MURBs	45
Deduction for investments in Canadian films	15
Total	*5,119*
Exemption tax expenditures	
Married and equivalent exemption	1,055
Exemption for wholly dependent children	655
Exemption for other dependents	25
Exemption for those over 65	185
Additional exemption for disabled	11
Total	*1,931*
Tax credit tax expenditures	
Refundable income-tested child tax credit	975
Tax credit for federal political contributions	6
Investment tax credit	105
Total	*1,086*

Source: Department of Finance, *Government of Canada Tax Expenditure Account* (Ottawa, December 1980).

TABLE A-10

Corporate Tax Expenditures, 1980
($ millions)

Tax expenditure	
Investment tax credit	440
Excess of tax depreciation over book depreciation	1,400
Reduced corporate tax rate on manufacturing	600
Two-year write-off of manufacturing assets	500
Immediate write-off of R&D expenditures and additional allowance of 50 percent of expenditures	97
Nontaxation of one-half capital gains	300
Exemptions and reductions of withholding tax	835
3 percent inventory valuation adjustment	370
Preferential treatment of income debentures and term-preferred shares	400
Deduction for charitable donations	50
Reduced small business tax rate	1,400
Total	*5,392*

Source: Department of Finance, *Government of Canada Tax Expenditure Account* (Ottawa, December 1980).

TABLE A-11

Sales and Excise Tax Expenditures, 1980
($ millions)

Tax expenditure	
Exemptions for:	
services	5,110
gasoline for commercial users	150
transportation equipment	265
energy conservation goods	17
$50,000 of manufacturing sales	20
nonmanufacturing commercial users of fuel	290
drugs	80
hospital purchases	125
health appliances	12
food and nonalcoholic beverages	2,370
home heating fuels and electricity	365
clothing and footwear	555
construction equipment	95
goods in competition with on-site construction and ready-mix concrete	105
construction materials purchased by educational institutions	32
technical and educational books	33
newspapers and magazines	54
bicycles, tricycles	10
artists' products	3
municipal purchases	85
provincial purchases	30
Reduced rate on building materials and equipment	445
Total	*10,246*

Source: Department of Finance, *Government of Canada Tax Expenditure Account* (Ottawa, December 1980).

Policy Analysis Committee

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